Oak Valley Bancorp
Form 10-Q
November 16, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2015

OR

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

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

California	**26-2326676**
State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

Issuer's telephone number

Not applicable

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

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,078,155 shares of common stock outstanding as of November 6, 2015.

Oak Valley Bancorp

September 30, 2015

Table of Contents

2

PART I – FINANCIAL STATEMENTS

Item 1. Consolidated Financial Statements (Unaudited)

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(dollars in thousands)	September 30, 2015	December 31, 2014
ASSETS		
Cash and due from banks	$ 136,594	$ 132,078
Federal funds sold	20,020	12,210
Cash and cash equivalents	156,614	144,288
Securities available for sale	129,497	121,277
Loans, net of allowance for loan loss of $7,389 and $7,534 at September 30, 2015 and December 31, 2014, respectively	469,616	446,492
Bank premises and equipment, net	13,736	14,066
Other real estate owned	834	884
Interest receivable and other assets	23,426	22,658
	$ 793,723	$ 749,665
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$ 712,577	$ 669,581
Interest payable and other liabilities	3,999	5,043
Total liabilities	716,576	674,624
Commitments and contingencies		
Shareholders' equity		
Preferred stock, 10,000,000 shares authorized, no shares issued and outstanding at September 30, 2015 and December 31, 2014	0	0
Common stock, no par value; 50,000,000 shares authorized, 8,078,155 and 8,074,855 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	24,682	24,682
Additional paid-in capital	3,107	2,910
Retained earnings	48,304	45,582
Accumulated other comprehensive income, net of tax	1,054	1,867
Total shareholders' equity	77,147	75,041
	$ 793,723	$ 749,665

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

4

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(dollars in thousands, except per share amounts)	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2015	2014	2015	2014
INTEREST INCOME				
Interest and fees on loans	$5,515	$5,555	$16,293	$16,202
Interest on securities available for sale	914	945	2,687	2,793
Interest on federal funds sold	8	6	24	30
Interest on deposits with banks	72	39	212	134
Total interest income	6,509	6,545	19,216	19,159
INTEREST EXPENSE				
Deposits	155	156	461	490
Total interest expense	155	156	461	490
Net interest income	6,354	6,389	18,755	18,669
(Reversal of) provision for loan losses	0	0	(125)	(1,877)
Net interest income after (reversal of) provision for loan losses	6,354	6,389	18,880	20,546
OTHER INCOME				
Service charges on deposits	307	364	927	1,009
Earnings on cash surrender value of life insurance	108	111	322	321
Mortgage commissions	26	60	114	138
Net gain on sales and calls of securities	3	17	186	29
Other	521	388	1,599	1,180
Total non-interest income	965	940	3,148	2,677
OTHER EXPENSES				
Salaries and employee benefits	2,852	2,796	8,790	8,210
Occupancy expenses	743	719	2,214	2,177
Data processing fees	366	339	1,077	995
Merger expenses	155	0	155	0
Regulatory assessments (FDIC & DBO)	123	118	368	358
Other operating expenses	1,061	1,140	2,986	3,242
Total non-interest expense	5,300	5,112	15,590	14,982
Net income before provision for income taxes	2,019	2,217	6,438	8,241
PROVISION FOR INCOME TAXES	638	682	2,020	2,761

NET INCOME	$1,381	$1,535	$4,418	$5,480
NET INCOME PER COMMON SHARE	$0.17	$0.19	$0.55	$0.69
NET INCOME PER DILUTED COMMON SHARE	$0.17	$0.19	$0.55	$0.69

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

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	THREE MONTHS ENDED SEPTEMBER 30, 2015	2014	NINE MONTHS ENDED SEPTEMBER 30, 2015	2014
Net income	$1,381	$1,535	$4,418	$5,480
Available for sale securities:				
Unrealized holding gains (losses) on securities arising during the current period, net of tax effect of $290 thousand and ($492) thousand for the three and nine month periods ended September 30, 2015, respectively, and $253 thousand and $1.5 million for the comparable 2014 periods	415	362	(704)	2,153
Reclassification adjustment due to net gains realized on sales and calls of securities, net of tax effect of $1 thousand and $77 thousand for the three and nine months ended September 30, 2015, respectively and $7 thousand and $12 thousand for the comparable 2014 periods	(2)	(10)	(109)	(17)
Other comprehensive income (loss)	413	352	(813)	2,136
Comprehensive income	$1,794	$1,887	$3,605	$7,616

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

6

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

	YEAR ENDED DECEMBER 31, 2014 AND NINE MONTHS ENDED SEPTEMBER 30, 2015							
	Common Stock		Preferred Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	Total Shareholders'
(dollars in thousands)	Shares	Amount	Shares	Amount	Capital	Earnings	Income (Loss)	Equity
Balances, January 1, 2014	7,929,730	$23,758	0	$ 0	$ 2,537	$38,985	$ (763)	$ 64,517
Stock options exercised	122,625	924						924
Tax benefit on stock based compensation					102			102
Restricted stock issued	24,500							
Restricted stock forfeited	(2,000)							
Cash dividends declared						(525)		(525)
Stock based compensation					271			271
Other comprehensive income							2,630	2,630
Net income						7,122		7,122
Balances, December 31, 2014	8,074,855	$24,682	0	$ 0	$ 2,910	$45,582	$ 1,867	$ 75,041
Restricted stock issued	6,000							
Restricted stock forfeited	(2,700)							
Cash dividends declared						(1,696)		(1,696)
Stock based compensation					197			197
Other comprehensive loss							(813)	(813)
Net income						4,418		4,418
Balances, September 30, 2015	8,078,155	$24,682	0	$ 0	$ 3,107	$48,304	$ 1,054	$ 77,147

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

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
(dollars in thousands)	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$4,418	$5,480
Adjustments to reconcile net earnings to net cash from operating activities:		
(Reversal of) provision for loan losses	(125)	(1,877)
Decrease in deferred fees/costs, net	(123)	(231)
Depreciation	892	471
Amortization of investment securities, net	132	120
Stock based compensation	197	209
Excess tax benefits from exercised stock options	0	(52)
Gain on sale of premises and equipment	(5)	(3)
OREO write downs	50	32
Gain on sales and calls of available for sale securities	(186)	(29)
Earnings on cash surrender value of life insurance	(322)	(321)
Gain on BOLI death benefit	(66)	0
Decrease in interest payable and other liabilities	(1,044)	(58)
Decrease in interest receivable	75	153
(Increase) decrease in other assets	(178)	483
Net cash from operating activities	3,715	4,377
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(34,506)	(18,389)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	24,958	15,475
Net increase in loans	(22,876)	(14,579)
Purchase of FHLB Stock	0	(104)
Purchase of BOLI policies	0	(1,029)
Proceeds from redemption of BOLI policies	292	0
Proceeds from sales of premises and equipment	5	3
Net purchases of premises and equipment	(562)	(401)
Net cash used in investing activities	(32,689)	(19,024)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Shareholder cash dividends paid	(1,696)	(1,318)
Net increase in demand deposits and savings accounts	43,078	30,316
Net decrease in time deposits	(82)	(2,771)
Excess tax benefits from exercised stock options	0	52
Proceeds from sale of common stock and exercise of stock options	0	924

Net cash from financing activities	41,300	27,203
NET INCREASE IN CASH AND CASH EQUIVALENTS	12,326	12,556
CASH AND CASH EQUIVALENTS, beginning of period	144,288	105,191
CASH AND CASH EQUIVALENTS, end of period	$156,614	$117,747
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$466	$512
Income taxes	$3,545	$2,075
NON-CASH INVESTING ACTIVITIES:		
Change in unrealized (loss) gain on available-for-sale securities	$(1,382)	$3,630

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

OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION

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

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

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

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

The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three and nine month periods ended September 30, 2015 are not necessarily indicative of the results of a full year's operations. Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders' equity as a result of reclassifications. For further information, refer to the audited consolidated financial statements and footnotes included in the Company's Form 10-K for the year ended December 31, 2014.

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

In January 2014, the FASB issued ASU No. 2014 – 01, *Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects.* This Update provides guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The adoption of ASU No. 2014-01 did not have a material impact on the Company's consolidated financial statements.

In January 2014, the FASB issued ASU No. 2014 – 04, *Receivables – Troubled Debt Restructurings by Creditors*. This ASU provides clarification that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of ASU No. 2014-04 did not have a material impact on the Company's consolidated financial statements.

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-14 *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40), Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.* This update addresses classification of government-guaranteed mortgage loans, including those where guarantees are offered by the Federal Housing Administration ("FHA"), the U.S. Department of Housing and Urban Development ("HUD"), and the U.S. Department of Veterans Affairs ("VA"). Although current accounting guidance stipulates proper measurement and classification in situations where a creditor obtains from a debtor, assets in satisfaction of a receivable (such as through foreclosure), current guidance does not specify how to measure and classify foreclosed mortgage loans that are government-guaranteed. Under the provisions of this update, a creditor would derecognize a mortgage loan that has been foreclosed upon, and recognize a separate receivable if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (2) At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, (3) At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. The amendments within this update are effective for annual and interim periods beginning after December 15, 2014. The adoption of ASU No. 2014-14 did not have a material impact on the Company's consolidated financial statements.

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

NOTE 3 – SECURITIES

The amortized cost and estimated fair values of debt securities as of September 30, 2015 are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 32,799	$ 1,315	$ (74)	$34,040
Collateralized mortgage obligations	3,662	39	(22)	3,679

Municipalities	63,016	1,480	(693)	63,803
SBA pools	823	0	(3)	820
Corporate debt	10,996	47	(15)	11,028
Asset backed securities	13,260	15	(163)	13,112
Mutual fund	3,149	0	(134)	3,015
	$ 127,705	$ 2,896	$ (1,104)	$ 129,497

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2015.

(dollars in thousands)	**Less than 12 months**		**12 months or more**		**Total**	
	Fair	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**
<u>Description of Securities</u>	**Value**	**Loss**	**Value**	**Loss**	**Value**	**Loss**
U.S. agencies	$ 1,262	$ (21)	$ 1,818	$ (53)	$ 3,080	$ (74)
Collateralized mortgage obligations	0	0	1,317	(22)	1,317	(22)
Municipalities	25,594	(519)	3,189	(174)	28,783	(693)
SBA pools	0	0	817	(3)	817	(3)
Corporate debt	2,479	(15)	0	0	2,479	(15)
Asset backed securities	4,938	(35)	4,759	(128)	9,697	(163)
Mutual fund	0	0	3,015	(134)	3,015	(134)
Total temporarily impaired securities	$ 34,273	$ (590)	$ 14,915	$ (514)	$ 49,188	$ (1,104)

At September 30, 2015, there was one U.S. agency, one collateralized mortgage obligations, five municipalities, two SBA pools, three asset backed securities and one mutual fund that comprised the total securities in an unrealized loss position for greater than 12 months and one U.S. agency, 23 municipalities, three corporate debts and two asset backed securities that make up the total securities in a loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The amortized cost and estimated fair value of investment securities at September 30, 2015, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands)	**Amortized Cost**	**Fair Value**
Available-for-sale securities:		
Due in one year or less	$ 11,396	$ 11,788
Due after one year through five years	38,658	39,756
Due after five years through ten years	41,765	41,454
Due after ten years	35,886	36,499
	$ 127,705	$ 129,497

The amortized cost and estimated fair values of investment securities as of December 31, 2014, are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 40,316	$ 1,760	$ (146)	$ 41,930
Collateralized mortgage obligations	6,927	184	(39)	7,072
Municipalities	49,396	1,713	(212)	50,897
SBA pools	895	0	(3)	892
Corporate debt	6,726	95	(17)	6,804
Asset backed securities	10,766	50	(106)	10,710
Mutual fund	3,077	0	(105)	2,972

$ 118,103	$ 3,802	$ (628)	$121,277

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2014.

(dollars in thousands)	Less than 12 months		12 months or more		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. agencies	$0	$ 0	$8,446	$ (146)	$8,446	$ (146)
Collateralized mortgage obligations	0	0	1,445	(39)	1,445	(39)
Municipalities	3,530	(22)	12,791	(190)	16,321	(212)
SBA pools	0	0	892	(3)	892	(3)
Corporate debt	1,983	(17)	0	0	1,983	(17)
Asset backed securities	3,798	(79)	971	(27)	4,769	(106)
Mutual fund	0	0	2,972	(105)	2,972	(105)
Total temporarily impaired securities	$9,311	$ (118)	$27,517	$ (510)	$36,828	$ (628)

We recognized gross gains of $3,000 and $218,000 for the three and nine month periods ended September 30, 2015, respectively, on certain available-for-sale securities that were called or sold, which compares to $17,000 and $29,000 in the same periods of 2014. The gains in 2015 reflected in the condensed consolidated statements of income are net of a $32,000 gross realized loss related to one available-for-sale securities sold during the first quarter of 2015, compared to no sales or calls of securities resulting in losses during the first nine months of 2014.

Securities carried at $67,922,000 and $60,474,000 at September 30, 2015 and December 31, 2014, respectively, were pledged to secure deposits of public funds.

NOTE 4 – LOANS

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of September 30, 2015, approximately 82% of the Company's loans are commercial real estate loans which include construction loans. Approximately 10% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 5% of the Company's loans are for residential real estate and other consumer loans. The remaining 3% are agriculture loans. Loan totals were as follows:

(in thousands)	September 30, 2015	December 31, 2014
Commercial real estate:		
Commercial real estate- construction	$ 24,205	$ 9,181
Commercial real estate- mortgages	331,895	315,506
Land	8,535	10,620
Farmland	27,704	23,091
Commercial and industrial	48,943	54,051
Consumer	638	805
Consumer residential	22,078	25,464
Agriculture	13,329	15,753
Total loans	477,327	454,471
Less:		
Deferred loan fees and costs, net	(322)	(445)
Allowance for loan losses	(7,389)	(7,534)
Net loans	$ 469,616	$ 446,492

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

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2015, commercial real estate loans equal to approximately 39.5% of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

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

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

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

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

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

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

(in thousands)	September 30, 2015	December 31, 2014
Commercial real estate:		
Commercial real estate- construction	$ 0	$ 0
Commercial real estate- mortgages	0	1,296
Land	2,918	2,995
Farmland	57	72
Commercial and industrial	1,314	337
Consumer	0	0
Consumer residential	0	0
Agriculture	0	0
Total non-accrual loans	$ 4,289	$ 4,700

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately $71,000 and $224,000 in the three and nine month periods ended September 30, 2015, as compared to $46,000 and $235,000 in the same periods of 2014.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of September 30, 2015 (in thousands):

September 30, 2015	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing
Commercial real estate:							
Commercial R.E. - construction	$0	$ 0	$0	$0	$24,205	$24,205	$ 0
Commercial R.E. - mortgages	469	0	0	469	331,426	331,895	0
Land	0	0	2,432	2,432	6,103	8,535	0
Farmland	0	0	57	57	27,647	27,704	0
Commercial and industrial	0	0	1,303	1,303	47,640	48,943	0
Consumer	0	0	0	0	638	638	0
Consumer residential	0	0	0	0	22,078	22,078	0
Agriculture	0	0	0	0	13,329	13,329	0
Total	$469	$ 0	$3,792	$4,261	$473,066	$477,327	$ 0

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2014 (in thousands):

December 31, 2014	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing
Commercial real estate:							
Commercial R.E. - construction	$ 0	$0	$0	$0	$9,181	$9,181	$ 0
Commercial R.E. - mortgages	35	1,296	0	1,331	314,175	315,506	0
Land	0	0	2,493	2,493	8,127	10,620	0

Farmland	0	0	72	72	23,019	23,091	0
Commercial and industrial	14	0	323	337	53,714	54,051	0
Consumer	0	0	0	0	805	805	0
Consumer residential	0	0	0	0	25,464	25,464	0
Agriculture	0	0	0	0	15,753	15,753	0
Total	$ 49	$1,296	$2,888	$4,233	$450,238	$454,471	$ 0

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. There was no interest income realized on impaired loans for the three and nine months ended September 30, 2015 and 2014. Average recorded investment in impaired loans was $4.33 million and $4.42 million for the three and nine months ended September 30, 2015, as compared to $3.81 million and $4.1 million for the same periods of 2014. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Impaired loans as of September 30, 2015 and December 31, 2014 are set forth in the following table.

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
September 30, 2015					
Commercial real estate:					
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	3,284	0	2,918	2,918	833
Farmland	0	57	0	57	0
Commercial and Industrial	1,379	326	988	1,314	70
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	0	0	0	0	0
Total	$ 4,663	$ 383	$ 3,906	$ 4,289	$ 903

December 31, 2014					
Commercial real estate:					
Commercial R.E. - construction	$0	$0	$0	$0	$0
Commercial R.E. - mortgages	1,301	0	1,296	1,296	125
Land	3,215	0	2,995	2,995	868
Farmland	80	72	0	72	0
Commercial and Industrial	359	337	0	337	0
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	0	0	0	0	0
Total	$4,956	$409	$4,291	$4,700	$993

Average recorded investment in impaired loans is set forth in the following table.

Average Recorded Investment for the:

(in thousands)	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2015	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014
Commercial real estate:				
Commercial R.E. - construction	$0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	216	0	523
Land	2,931	2,961	3,383	3,202
Farmland	59	64	80	85
Commercial and Industrial	1,335	1,182	345	293
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total	$4,325	$ 4,423	$ 3,808	$ 4,103

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

At September 30, 2015, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $3,244,000. At December 31, 2014, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $3,332,000. At September 30, 2015 and December 31, 2014 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated $833,000 and $868,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of September 30, 2015 and December 31, 2014, respectively.

The modification of the terms of such loans typically includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan is conceded. During the three months ended September 30, 2015 and 2014, no loans were modified as troubled debt restructurings. During the nine months ended September 30, 2015, two loans were modified as troubled debt restructurings by extending the maturity dates, as compared to four loans that were modified during the nine month period of 2014 by reducing the interest rates and extending the maturity dates.

The following tables presents loans by class modified as troubled debt restructurings that occurred during the nine month periods ended September 30, 2015 and 2014:

(dollars in thousands)	Nine Months Ended September 30, 2015			Nine Months Ended September 30, 2014		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate:						
Commercial R.E. - construction	0	$ 0	$ 0	0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0	0
Land	1	570	570	3	3,107	3,107
Farmland	0	0	0	0	0	0
Commercial and industrial	1	24	24	1	331	331

Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0
Agriculture	0	0	0	0	0	0
Total	2	$ 594	$ 594	4	$ 3,438	$ 3,438

The troubled debt restructuring during the nine months ended September 30, 2015 did not increase the allowance for loan losses as a result of loan modifications. There were no charge-offs as a result of loan modifications, as the contractual balances outstanding were determined to be collectible.

There were no loans modified as troubled debt restructurings within the previous twelve months and for which there was a payment default during the three and nine month periods ended September 30, 2015, compared to one commercial real estate land loan with a balance of $54,000 that was modified and defaulted during the nine month period of 2014. There were no such payment defaults on modified loans during the three months ended September 30, 2014. A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

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

We grade loans using the following letter system:

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

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

-A high level of liquidity and whose debt-servicing capacity exceeds expected obligations by a substantial margin.

-Where leverage is below average for the industry and earnings are consistent or growing without severe vulnerability to economic cycles.

-Also included in this rating (but not mandatory unless one or more of the preceding characteristics are missing) are loans that are fully secured and properly margined by our own time instruments or U.S. blue chip securities. To be properly margined cash collateral must be equal to, or greater than, 110% of the loan amount.

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

-Unquestionable debt-servicing capacity to cover all obligations in the ordinary course of business from well-defined primary and secondary sources.

-Consistent strong earnings.

-A solid equity base.

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

-Strong earnings with no loss in last three years and ample cash flow to service all debt well above policy guidelines.

-Long term experienced management with depth and defined management succession.

-The loan has no exceptions to policy.

-Loan-to-value on real estate secured transactions is 10% to 20% less than policy guidelines.

-Very liquid balance sheet that may have cash available to pay off our loan completely.

-Little to no debt on balance sheet.

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

-Are those where the borrower has average financial strengths, a history of profitable operations and experienced management.

-Are those where the borrower can be expected to handle normal credit needs in a satisfactory manner.

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

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

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

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

-The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.

-Questions exist regarding the condition of and/or control over collateral.

-Economic or market conditions may unfavorably affect the obligor in the future.

-A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized.

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

7 Doubtful Loan - An extension of credit classified "doubtful" has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Bank. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent.

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

_8_ _*Loss*_ - Extensions of credit classified "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off, even though partial recovery may be affected in the future. It should not be the Company's practice to attempt long-term recoveries while the credit remains on the books. Losses should be taken in the period in which they surface as uncollectible.

As of September 30, 2015 and December 31, 2014, there are no loans that are classified with a risk grade of *8- Loss.*

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

	September 30, 2015	December 31, 2014
	Weighted Average Risk Grade	Weighted Average Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.35	3.00
Commercial real estate - mortgages	3.13	3.15
Land	4.47	4.34
Farmland	3.01	3.01
Commercial and industrial	3.50	3.39
Consumer	2.32	2.11
Consumer residential	3.01	3.02
Agriculture	3.20	3.18
Total gross loans	3.19	3.19

The following table presents risk grade totals by class of loans as of September 30, 2015 and December 31, 2014. Risk grades 1 through 4 have been aggregated in the "Pass" line.

(in thousands)	Commercial R.E. Construction	Commercial R.E. Mortgages	Land	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
September 30, 2015									
Pass	$ 24,205	$ 328,951	$ 5,617	$ 27,648	$ 43,154	$ 608	$ 22,029	$ 13,329	$ 465,541
Special mention	-	2,739	-	-	4,361	-	-	-	7,100
Substandard	-	205	2,918	56	1,428	30	49	-	4,686
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 24,205	$ 331,895	$ 8,535	$ 27,704	$ 48,943	$ 638	$ 22,078	$ 13,329	$ 477,327
December 31, 2014									
Pass	$ 9,181	$ 310,912	$ 7,625	$ 23,019	$ 48,997	$ 790	$ 25,283	$ 15,753	$ 441,560
Special mention	-	2,722	-	-	3,438	-	-	-	6,160
Substandard	-	1,872	2,995	72	1,616	15	181	-	6,751
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 9,181	$ 315,506	$ 10,620	$ 23,091	$ 54,051	$ 805	$ 25,464	$ 15,753	$ 454,471

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

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

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

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

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

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

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

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

The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2015 and 2014. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

Allowance for Loan Losses
For the Three and Nine Months Ended September 30, 2015 and 2014

(in thousands) **<u>Three Months Ended September 30, 2015</u>**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 5,884	$ 583	$ 45	$ 480	$ 263	$ 135	$7,390
Charge-offs	0	0	(2)	0	0	0	(2)
Recoveries	1	0	0	0	0	0	1
Provision for (reversal of) loan losses	12	90	(2)	(14)	(15)	(71)	0
Ending balance	$ 5,897	$ 673	$ 41	$ 466	$ 248	$ 64	$7,389

Nine Months Ended September 30, 2015							
Beginning balance	$ 5,963	$ 720	$ 42	$ 388	$ 286	$ 135	$7,534
Charge-offs	0	0	(24)	0	0	0	(24)
Recoveries	2	0	2	0	0	0	4
(Reversal of) provision for loan losses	(68)	(47)	21	78	(38)	(71)	(125)
Ending balance	$ 5,897	$ 673	$ 41	$ 466	$ 248	$ 64	$7,389
Three Months Ended September 30, 2014							
Beginning balance	$ 6,256	$ 560	$ 51	$ 430	$ 261	$ 44	$7,602
Charge-offs	(53)	0	(10)	0	0	0	(63)
Recoveries	1	0	0	1	0	0	2
(Reversal of) provision for loan losses	(164)	111	6	(5)	(35)	87	0
Ending balance	$ 6,040	$ 671	$ 47	$ 426	$ 226	$ 131	$7,541
Nine Months Ended September 30, 2014							
Beginning balance	$ 6,247	$ 663	$ 47	$ 440	217	$ 45	$7,659
Charge-offs	(103)	0	(28)	0	0	0	(131)
Recoveries	1,878	0	1	11	0	0	1,890
(Reversal of) provision for loan losses	(1,982)	8	27	(25)	9	86	(1,877)
Ending balance	$ 6,040	$ 671	$ 47	$ 426	$ 226	$ 131	$7,541

The following table details the allowance for loan losses and ending gross loan balances as of September 30, 2015, December 31, 2014 and September 30, 2014 summarized by collective and individual evaluation methods of impairment.

(in thousands)	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
September 30, 2015							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 833	$ 70	$ 0	$ 0	$ 0	$ 0	$903
Collectively evaluated for impairment	5,064	603	41	466	248	64	6,486
	$ 5,897	$ 673	$ 41	$ 466	$ 248	$ 64	$7,389
Ending gross loan balances:							
Individually evaluated for impairment	$ 2,975	$ 1,314	$ 0	$ 0	$ 0	$ 0	$4,289
Collectively evaluated for impairment	389,364	47,629	638	22,078	13,329	0	473,038
	$ 392,339	$ 48,943	$ 638	$ 22,078	$ 13,329	$ 0	$477,327
December 31, 2014							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 993	$ 0	$ 0	$ 0	$ 0	$ 0	$993
Collectively evaluated for impairment	4,970	720	42	388	286	135	6,541
	$ 5,963	$ 720	$ 42	$ 388	$ 286	$ 135	$7,534
Ending balances of loans:							
Individually evaluated for impairment	$ 4,363	$ 337	$ 0	$ 0	$ 0	$ 0	$4,700
Collectively evaluated for impairment	354,035	53,714	805	25,464	15,753	0	449,771
	$ 358,398	$ 54,051	$ 805	$ 25,464	$ 15,753	$ 0	$454,471
September 30, 2014							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 873	$ 0	$ 0	$ 0	$ 0	$ 0	$873
Collectively evaluated for impairment	5,167	671	47	426	226	131	6,668

	$ 6,040	$ 671	$ 47	$ 426	$ 226	$ 131	$7,541
Ending gross loan balances:							
Individually evaluated for impairment	$ 3,108	$ 341	$ 0	$ 0	$ 0	$ 0	$3,449
Collectively evaluated for impairment	345,503	47,856	861	25,944	12,163	0	432,327
	$ 348,611	$ 48,197	$ 861	$ 25,944	$ 12,163	$ 0	$435,776

21

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

(in thousands)	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2015	**2014**	**2015**	**2014**
Balance, beginning of period	$ 234	$ 148	$ 218	$ 134
Provision to operations for off balance sheet commitments	23	46	39	60
Balance, end of period	$ 257	$ 194	$ 257	$ 194

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

At September 30, 2015 and December 31, 2014, loans carried at $477,327,000 and $454,471,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

NOTE 5 – OTHER REAL ESTATE OWNED

As of September 30, 2015 and December 31, 2014, the Company owned three properties classified as other real estate with outstanding balances of $834,000 and $884,000, respectively, which includes one property consisting of residential land that was written down to a zero balance. Each of these properties was acquired through loan foreclosure. The residential land property the Company owned at September 30, 2015 and December 31, 2014, was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. There were no sales of OREO property during the nine months ended September 30, 2015 and 2014.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of carrying amount of the loan or fair value of the property at the date of foreclosure less selling costs. Subsequent to foreclosure, valuations are periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure. Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

NOTE 6– OTHER POST-RETIREMENT BENEFIT PLANS

During January 2008, the Bank awarded certain officers a salary continuation plan (the "Plan"). Under the Plan, the participants will be provided with a fixed annual retirement benefit for twenty years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Bank purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Bank and are available to satisfy the Company's general creditors.

The Bank awarded a director retirement plan ("DRP") to two of its directors in January 2008 and to three of its newest directors in March 2014. Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the DRP. In connection with the implementation of the DRP, the Bank purchased single premium life insurance policies on the life of each director covered under the DRP. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Bank and are available to satisfy the Bank's general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Bank accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Bank's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years. The salary continuation liability as of September 30, 2015 and December 31, 2014 was $2,380,000 and $2,222,000, respectively, and is reported in interest payable and other liabilities on the condensed consolidated balance sheets.

During January 2008, the Bank purchased $4.7 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with certain officers and direors. During March 2014, the Bank purchased an additional $1.0 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with its three newest directors. In connection with the implementation of the split-dollar agreements, the Bank purchased single premium life insurance policies on the life of each of the officers and directors covered by the split-dollar life insurance agreements. The Bank is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies recorded in interest receivable and other assets on the condensed consolidated balance sheets were $13,640,000 and $13,549,000 at September 30, 2015 and December 31, 2014, respectively.

NOTE 7 — FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Fair values of financial instruments — The consolidated financial statements include various estimated fair value information as of September 30, 2015 and December 31, 2014. Such information, which pertains to the Company’s financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

Fair value measurements defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

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

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

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

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company’s quarterly valuation process. There were no transfers between levels during the three and nine month periods ended September 30, 2015 or 2014.

Following is a description of valuation methodologies used for assets and liabilities in the tables below:

Cash and cash equivalents – The carrying amounts of cash and cash equivalents approximate their fair value and are considered a level 1 valuation.

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

Loans receivable — For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. The Company’s fair value model takes into account many inputs including current market rates on new loans, the U.S. treasury yield curve, LIBOR yield curve, rate floors, rate ceilings, remaining maturity, and average life based on specific loan type. Net loans are considered to be a level 3 valuation.

Deposit liabilities — The fair values estimated for demand deposits (interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of the aggregate expected monthly maturities on time deposits. The fair value of deposits is determined by the Company’s internal assets and liabilities modeling system that accounts for various inputs such as decay rates, rate floors, FHLB yield curve, maturities and current rates offered on new accounts. Fair value on deposits is considered a level 3 valuation.

Interest receivable and payable - The carrying amounts of accrued interest approximate their fair value and are considered to be a level 2 valuation.

Off-balance-sheet instruments — Fair values for the Bank's off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the counterparties. The Company considers the Bank's off balance sheet instruments to be a level 3 valuation.

The estimated fair values of the Company's financial instruments not measured at fair value at September 30, 2015 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$156,614	156,614	1
Restricted equity securities	3,417	3,417	2
Loans, net	469,616	476,167	3
Interest receivable	1,949	1,949	2
Financial liabilities:			
Deposits	(712,577)	(642,949)	3
Interest payable	(34)	(34)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(996)	3

The estimated fair values of the Company's financial instruments not measured at fair value at December 31, 2014 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$144,288	$144,288	1
Restricted equity securities	3,275	3,275	2
Loans, net	446,492	455,501	3
Interest receivable	2,024	2,024	2
Financial liabilities:			
Deposits	(669,581)	(600,941)	3
Interest payable	(39)	(39)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(848)	3

The following table presents the carrying value of recurring and nonrecurring financial instruments that were measured at fair value and that were still held in the condensed consolidated balance sheets at each respective period end, by level within the fair value hierarchy as of September 30, 2015 and December 31, 2014.

	Fair Value Measurements at September 30, 2015 Using			
(in thousands)	**September 30, 2015**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	$34,040	$ 0	$ 34,040	$ 0
Collateralized mortgage obligations	3,679	0	3,679	0
Municipalities	63,803	0	63,803	0
SBA pools	820	0	820	0
Corporate debt	11,028	0	11,028	0
Asset backed securities	13,112	0	13,112	
Mutual fund	3,015	3,015	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	$1,322	$ 0	$ 0	$ 1,322
Other real estate owned	834	0	0	834

	Fair Value Measurements at December 31, 2014 Using			
(in thousands)	**December 31, 2014**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities				

U.S. agencies	$41,930	$ 0	$ 41,930	$ 0
Collateralized mortgage obligations	7,072	0	7,072	0
Municipalities	50,897	0	50,897	0
SBA pools	892	0	892	0
Corporate debt	6,804	0	6,804	0
Asset backed securities	10,710	0	10,710	0
Mutual fund	2,972	2,972	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	$1,743	$ 0	$ 0	$ 1,743
Commercial real estate - mortgages	1,171	0	0	1,171
Other real estate owned	884	0	0	884

25

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

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

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

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

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

There have been no significant changes in the valuation techniques during the period ended September 30, 2015.

NOTE 8 – EARNINGS PER SHARE

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

The Company's calculation of basic and diluted earnings per share ("EPS") for the three and nine month periods ended September 30, 2015 and 2014 are reflected in the table below.

(In thousands)	**THREE MONTHS ENDED SEPTEMBER 30,**	
	2015	**2014**
BASIC EARNINGS PER SHARE		
Net income	$1,381	$1,535
Weighted average shares outstanding	7,995	7,959
Net income per common share	$0.17	$0.19
DILUTED EARNINGS PER SHARE		
Net income	$1,381	$1,535
Weighted average shares outstanding	7,995	7,959
Effect of dilutive stock options	1	2
Effect of dilutive non-vested restricted shares	45	50
Weighted average shares of common stock and common stock equivalents	8,041	8,011
Net income per diluted common share	$0.17	$0.19

(In thousands)	NINE MONTHS ENDED SEPTEMBER 30, 2015	2014
BASIC EARNINGS PER SHARE		
Net income	$4,418	$5,480
Weighted average shares outstanding	7,987	7,931
Net income per common share	$0.55	$0.69
DILUTED EARNINGS PER SHARE		
Net income	$4,418	$5,480
Weighted average shares outstanding	7,987	7,931
Effect of dilutive stock options	1	6
Effect of dilutive non-vested restricted shares	46	48
Weighted average shares of common stock and common stock equivalents	8,034	7,985
Net income per diluted common share	$0.55	$0.69

During the three and nine month periods ended September 30, 2015, anti-dilutive weighted average options to purchase 45,128 and 52,945 shares of common stock were outstanding, respectively, with prices ranging from $9.95 to $15.67. Anti-dilutive weighted average stock options of 59,500 and 68,500 were outstanding during the three and nine month periods of 2014, respectively, with prices ranging from $9.95 to $15.67. These options were not included in the computation of diluted EPS because the options’ exercise price was greater than the average market price of the common shares. These options begin to expire in 2015.

There were no anti-dilutive non-vested restricted stock grants for the three and nine months ended September 30, 2015 and 2014.

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear or that are referenced to elsewhere in this report, and with the audited consolidated financial statements and accompanying notes included in our 2014 Annual Report on Form 10-K, as amended. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

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

Forward-Looking Statements

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

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

Critical Accounting Estimates

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

Allowance for Loan Losses

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

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

the specific review of individual loans,

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

our judgmental estimate based on various subjective factors.

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

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

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

concentration of credits,

nature and volume of the loan portfolio,

delinquency trends,

non-accrual loan trend,

problem loan trend,

loss and recovery trend,

quality of loan review,

lending and management staff,

lending policies and procedures,

economic and business conditions, and

other external factors, including regulatory review.

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

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

Non-Accrual Loan Policy

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

Asset Impairment Judgments

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

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

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

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

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

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

Fair Value Measurements

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

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

Deferred Compensations Plans

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

Introduction

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

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

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

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

Overview of Results of Operations and Financial Condition

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

Management believes the following were important factors in the Company's performance during the three and nine month periods ended September 30, 2015:

- The Company recognized net income of $1,381,000 and $4,418,000 for the three and nine month periods ended September 30, 2015, respectively, as compared to $1,535,000 and $5,480,000 for the same periods in 2014. The factors contributing to these results will be discussed below.

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The Company recognized no loan loss provisions during the third quarter of 2015 and a $125,000 reversal of loan loss provisions during the nine month period of 2015. This compares to no provisions recorded during the third quarter of 2014 and $1,877,000 reversal of loan loss provisions during the nine month periods of 2014, which was largely a function of a loan settlement of $2,923,000 which resulted in a net loan recovery of $1,877,000.

- Net interest income decreased $35,000 or 0.5% and increased $86,000 or 0.5% for the three and nine month periods ended September 30, 2015, respectively, compared to the same periods in 2014. The year-to-date increase was primarily due to growth of our loan and investment security portfolios, which is offsetting the decrease we're experiencing in loan and investments yields as reflected in the quarterly decrease.

- Non-interest income increased by $25,000 or 2.7% and $471,000 or 17.6% for the three and nine months ended September 30, 2015, respectively, as compared to the same periods in 2014. The year-to-date increase was primarily from nonrecurring items recorded in other income earned during 2015, as described in further detail below.

- Non-interest expense increased by $188,000 or 3.7% and $608,000 or 4.1% for the three and nine month periods ended September 30, 2015, respectively, as compared to the same periods in 2014. The increase was mainly due to an increase in staffing necessary to support the loan and deposit growth and the opening of our Tracy branch in December 2014. In addition, the third quarter included merger related expenses of $155,000 pertaining to the Company's pending acquisition of Mother Lode Bank scheduled to be completed in December 2015.

- Total assets increased $44.1 million or 5.9% from December 31, 2014. Total net loans increased by $23.1 million or 5.2% and investment securities increased by $8.2 million or 6.8% from December 31, 2014 to September 30, 2015, while deposits increased by $43.0 million or 6.4% for the same period.

Income Summary

For the three and nine month periods ended September 30, 2015, the Company recorded net income of $1,381,000 and $4,418,000, respectively, representing decreases of $154,000 and $1,062,000, as compared to the same periods in 2014. Return on average assets (annualized) was 0.70% and 0.77% for the three and nine months ended September 30, 2015, respectively, as compared with 0.88% and 1.07%, for the same periods in 2014. Annualized return on average common equity was 7.17% and 7.77% for the three and nine months ended September 30, 2015, respectively, as compared to 8.44% and 10.53% for the same periods of 2014.

Net income before provisions for income taxes decreased $198,000 and $1,803,000 for the three and nine month periods ended September 30, 2015, respectively, from the comparable 2014 periods. The income statement components of these variances are as follows:

Pre-Tax Income Variance Summary:

(In thousands)	**Effect on Pre-Tax Income** ***Increase (Decrease)*** **Three Months Ended September 30, 2015**	**Effect on Pre-Tax Income** ***Increase (Decrease)*** **Nine months ended September 30, 2015**
Change from 2014 to 2015 in:		
Net interest income	$ (35)	$ 86
Provision for loan losses	0	(1,752)
Non-interest income	25	471
Non-interest expense	(188)	(608)
Change in net income before income taxes	$ (198)	$ (1,803)

These variances will be explained in the discussion below.

Net Interest Income

Net interest income is the largest source of the Company’s operating income. For the three and nine month periods ended September 30, 2015, net interest income was $6.4 million and $18.8 million, respectively, which represented a decrease of $35,000 or 0.5% and an increase of $86,000 or 0.5% from the comparable periods in 2014.

The net interest margin (net interest income as a percentage of average interest earning assets) was 3.61% and 3.68% for the three and nine months period ended September 30, 2015, respectively, which declined compared to 4.13% and 4.08% for the same periods in 2014. Overall, the Company has experienced net interest margin compression since the economic downturn in 2010 for several reasons: 1) deposit interest rates have essentially reached a threshold in which they cannot reasonably be further reduced, 2) competition in the lending market has driven new loan rates down, 3) loan and investment portfolio yields continue to decrease due to contractual repricing and 4) deposit growth has out-paced loan growth and the elevated interest-bearing cash balances, which yield approximately 0.25%, have compressed our net interest margin.

The cost of funds on interest-bearing liabilities did recognize a moderate decrease of 2 basis points for the three and nine months ended September 30, 2015, compared to the same periods of 2014 due to further rate reductions mainly from certificate of deposit accounts that matured and renewed at lower rates. In addition, average non-interest-bearing demand deposit balances increased by $24.5 million and $24.7 million, for the three and nine month periods ended September 30, 2015, respectively, as compared to the same periods of 2014.

Earning asset yield decreased by 54 basis points and 42 basis points for the three and nine month periods ended September 30, 2015, respectively, compared to the same periods of 2014. The yield on loans decreased by 35 basis points for the third quarter and nine month period of 2015, as compared to 2014, in spite of the significant portion of our loans that are at their contractual rate floors. This decrease in loan yield was primarily a result of competitive pressure on the pricing of new loan fundings and a decrease in loan fee income recognition. The drop in loan yield was offset by deploying a portion of the low yielding cash equivalent balances into the loan and investment portfolios which recognized average balance increases of $33.8 million and $2.9 million, respectively, in the nine month period of 2015 as compared to 2014.

The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2015 and 2014:

Net Interest Analysis

(in thousands)	**Three Months Ended September 30, 2015** Average Balance	Interest Income / Expense	Avg Rate/ Yield	**Three Months Ended September 30, 2014** Average Balance	Interest Income / Expense	Avg Rate/ Yield
Assets:						
Earning assets:						
Gross loans (1) (2)	$468,060	$ 5,515	4.67 %	$439,108	$ 5,557	5.02 %
Investment securities (2)	128,637	1,150	3.55 %	124,271	1,142	3.65 %
Federal funds sold	12,819	8	0.25 %	10,300	6	0.23 %
Interest-earning deposits	114,951	72	0.25 %	58,938	39	0.26 %
Total interest-earning assets	724,467	6,745	3.69 %	632,617	6,744	4.23 %
Total noninterest earning assets	55,178			57,935		
Total Assets	779,645			690,552		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
Interest-earning DDA	20,844	2	0.04 %	15,865	2	0.05 %
Money market deposits	269,095	72	0.10 %	234,497	68	0.12 %
NOW deposits	112,672	19	0.07 %	97,935	15	0.06 %
Savings deposits	50,239	15	0.12 %	39,770	11	0.11 %
Time certificates of deposit $100,000 or more	30,736	35	0.46 %	33,639	48	0.57 %
Other time deposits	16,049	12	0.31 %	17,364	12	0.28 %
Other borrowings	0	0	0.00 %	0	0	0.00 %
Total interest-bearing liabilities	499,635	155	0.12 %	439,070	156	0.14 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	199,885			175,438		
Other liabilities	3,626			3,920		
Total noninterest-bearing liabilities	203,511			179,358		
Shareholders' equity	76,499			72,124		
Total liabilities and shareholders' equity	$779,645			$690,552		
Net interest income		$ 6,590			$ 6,588	
Net interest spread (3)			3.57 %			4.09 %
Net interest margin (4)			3.61 %			4.13 %

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

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

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

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

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

(in thousands)	**Nine months ended September 30, 2015** Average Balance	Interest Income / Expense	Avg Rate/ Yield	**Nine months ended September 30, 2014** Average Balance	Interest Income / Expense	Avg Rate/ Yield
Assets:						
Earning assets:						
Gross loans (1) (2)	$459,383	$ 16,295	4.74 %	$425,552	$ 16,208	5.09 %
Investment securities (2)	124,514	3,356	3.60 %	121,663	3,347	3.68 %
Federal funds sold	13,787	24	0.23 %	17,048	30	0.24 %
Interest-earning deposits	108,237	212	0.26 %	65,494	134	0.27 %
Total interest-earning assets	705,921	19,888	3.77 %	629,757	19,719	4.19 %
Total noninterest earning assets	56,582			54,282		
Total assets	762,503			684,039		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
Interest-earning DDA	17,471	5	0.04 %	13,897	4	0.04 %
Money market deposits	263,735	207	0.10 %	238,466	209	0.12 %
NOW deposits	111,117	56	0.07 %	95,324	48	0.07 %
Savings deposits	46,730	40	0.11 %	40,283	34	0.11 %
Time certificates of deposit $100,000 or more	30,902	113	0.49 %	33,591	145	0.58 %
Other time deposits	16,698	39	0.31 %	17,879	50	0.37 %
Other borrowings	16	1	0.00 %	2	0	0.00 %
Total interest-bearing liabilities	486,669	461	0.13 %	439,442	490	0.15 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	195,733			170,988		
Other liabilities	4,091			4,048		
Total noninterest-bearing liabilities	199,824			175,036		
Shareholders' equity	76,010			69,561		
Total liabilities and shareholders' equity	$762,503			$684,039		
Net interest income		$ 19,427			$ 19,229	
Net interest spread (3)			3.64 %			4.04 %
Net interest margin (4)			3.68 %			4.08 %

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

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

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

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

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

Shown in the following tables are the relative impacts on net interest income of changes in the average outstanding balances (volume) of earning assets and interest bearing liabilities and the rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2015 and 2014. Changes in interest income and expense that are not attributable specifically to either rate or volume are allocated to the rate column below.

Rate / Volume Variance Analysis

(In thousands)

(in thousands)	**For the Three Months Ended September 30, 2015 vs 2014 Increase (Decrease) in interest income and expense due to changes in:**		
	Volume	**Rate**	**Total**
Interest income:			
Gross loans (1) (2)	$366	$(408)	$(42)
Investment securities (2)	40	(32)	8
Federal funds sold	1	1	2
Interest-earning deposits	37	(4)	33
Total interest income	**$444**	**$(443)**	**$1**
Interest expense:			
Interest-earning DDA	1	(1)	0
Money market deposits	10	(6)	4
NOW deposits	2	2	4
Savings deposits	3	1	4
Time CD $100K or more	(4)	(9)	(13)
Other time deposits	(1)	1	0
Other borrowings	0	0	0
Total interest expense	**$11**	**$(12)**	**$(1)**
Change in net interest income	**$433**	**$(431)**	**$2**

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

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

The table above reflects how the current low interest rate environment has impacted assets more than liabilities as indicated by the decrease of $431,000 in net interest income due to the rate change for the third quarter of 2015. This is not typical for the Company, as we have historically been liability sensitive, however, deposit interest rates are at historic lows and have essentially reached a threshold in which they cannot reasonably be further reduced and existing loans are continuing to reprice downward while new loans are funding at historically low rates. The decrease in loan yields resulted in a $408,000 decrease to loan interest income for the quarter compared to prior year. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of $433,000 to net interest income over the same period.

(in thousands)	For the Nine Months Ended September 30, 2015 vs 2014 Increase (Decrease) in interest income and expense due to changes in:		
	Volume	**Rate**	**Total**
Interest income:			
Gross loans (1) (2)	$1,289	$(1,201)	$88
Investment securities (2)	78	(69)	9
Federal funds sold	(6)	0	(6)
Interest-earning deposits	87	(9)	78
Total interest income	**$1,448**	**$(1,279)**	**$169**
Interest expense:			
Interest-earning DDA	$1	$-	$1
Money market deposits	22	(23)	(1)
NOW deposits	8	0	8
Savings deposits	5	1	6
Time CD $100K or more	(12)	(20)	(32)
Other time deposits	(3)	(8)	(11)
Other borrowings	0	0	0
Total interest expense	**$21**	**$(50)**	**$(29)**
Change in net interest income	**$1,427**	**$(1,229)**	**$198**

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

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

The table above reflects how the current low interest rate environment has impacted assets more than liabilities as indicated by the decrease of $1,227,000 in net interest income due to the rate change for the nine month period of 2015. This is not typical for the Company, as we have historically been liability sensitive, however, deposit interest rates are at historic lows and have essentially reached a threshold in which they cannot reasonably be further reduced and existing loans are continuing to reprice downward while new loans are funding at historically low rates. The decrease in loan yields resulted in a $1,201,000 decrease to loan interest income year-to-date compared to last year. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of $1,427,000 to net interest income over the same period.

Non-Interest Income

Non-interest income represents service charges on deposit accounts and other non-interest related charges and fees, including fees from mortgage commissions and investment service fee income. For the three and nine month periods ended September 30, 2015, non-interest income was $965,000 and $3,148,000, representing increases of $25,000 or 2.7% and $471,000 or 17.6%, respectively, compared to the same periods in 2014.

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

(in thousands)	For the Three Months Ended September 30,			
	2015	**2014**	**$ change**	**% change**
Service charges on deposits	$307	$364	$ (57)	(15.7%)
Earnings on cash surrender value of life insurance	108	111	(3)	(2.7%)
Mortgage commissions	26	60	(34)	(56.7%)
Gains on sales and calls of securities	3	17	(14)	(82.4%)
Other income	521	388	133	34.3%
Total non-interest income	$965	$940	$ 25	2.7%

(in thousands)	For the Nine Months Ended September 30,			
	2015	**2014**	**$ change**	**% change**
Service charges on deposits	$927	$1,009	$ (82)	(8.1%)
Earnings on cash surrender value of life insurance	322	321	1	0.3%
Mortgage commissions	114	138	(24)	(17.4%)
Net gain on sales and calls of securities	186	29	157	541.4%
Other income	1,599	1,180	419	35.5%
Total non-interest income	$3,148	$2,677	$ 471	17.6%

Service charges on deposits decreased by $57,000 and $82,000 for the three and nine months ended September 30, 2015, respectively, compared to the same periods in 2014, as a result of a decrease in overdraft activity and corresponding overdraft fees on transaction deposit accounts.

Mortgage commissions decreased by $34,000 and $24,000 for the three and nine months ended September 30, 2015, respectively, as compared to the same periods of 2014, as a result of lower demand for home purchases and refinancing.

Net gain on sales and calls of securities decreased by $14,000 in the third quarter of 2015 but still reflected an increase of $157,000 year-to-date, as compared to the same periods in 2014, mainly due to an increase in calls and sales of securities.

Other income increased by $133,000 and $419,000 for the three and nine month periods ended September 30, 2015, as compared to the same periods of 2014, mainly as a result of the year-to-date increases of $125,000 in FHLB stock dividend income, a non-recurring life insurance death benefit of $66,000, the elimination of our checking rewards program in December 2014 that saved $147,000 in reward payments and an increase of $51,000 in debit card fee income.

Non-Interest Expense

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

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

(in thousands)	**For the Three Months Ended September 30,**			
	2015	**2014**	**$ change**	**% change**
Salaries and employee benefits	$2,852	$2,796	$ 56	2.0 %
Occupancy	743	719	24	3.3 %
Data processing fees	366	339	27	8.0 %
Merger Expenses	155	0	155	-
Regulatory assessments (FDIC & DBO)	123	118	5	4.2 %
Other	1,061	1,140	(79)	(6.9%)
Total non-interest expense	$5,300	$5,112	$ 188	3.7 %

(in thousands)	**For the Nine Months Ended September 30,**			
	2015	**2014**	**$ change**	**% change**
Salaries and employee benefits	$8,790	$8,210	$ 580	7.1 %
Occupancy	2,214	2,177	37	1.7 %
Data processing fees	1,077	995	82	8.2 %
Merger Expenses	155	0	155	-
Regulatory assessments (FDIC & DBO)	368	358	10	2.8 %
Other	2,986	3,242	(256)	(7.9%)
Total non-interest expense	$15,590	$14,982	$ 608	4.1 %

37

Non-interest expenses increased by $188,000 or 3.7% and $608,000 or 4.1% for the three and nine months ended September 30, 2015, respectively, as compared to the same periods of 2014. Salaries and employee benefits increased $56,000 and $580,000 for the three and nine months ended September 30, 2015, respectively, as compared to the same periods of 2014, primarily due to full time equivalent staffing increase from 144 to 152 to support continued loan and deposit growth and the opening of our Tracy branch in December 2014.

Data processing fees increased by $27,000 and $82,000 for the three and nine month periods ended September 30, 2015, respectively, as a result of an increased number of transaction accounts. Other expense decreased by $79,000 and $256,000 for the three and nine months ended September 30, 2015, respectively, compared to the same periods in 2014, mainly as a result of a recovery of impaired loan expense recorded during the first quarter of 2015, corresponding to the payoff of a non-performing loan which was partially offset by a combination of expenses incurred to support the growth of our product lines and services.

FDIC and DBO (California Department of Business Oversight) regulatory assessments increased by $5,000 and $10,000 for the three and nine months ended September 30, 2015, respectively, as compared to the same periods in 2014. The initial base assessment rate for financial institutions varies based on the overall risk profile of the institution as defined by the FDIC. The assessment rate decreased as a result of our improved risk profile, but was offset by a higher deposit base in 2015 as compared to 2014, as the FDIC assessment rates are applied to average quarterly total liabilities as the primary basis.

Merger Expenses totaled $155,000 during the third quarter and are attributable to the pending acquisition of Mother Lode Bank which is scheduled to be completed in December of 2015. These expenses consist of professional fees, including legal, accounting and investment banker fees.

Occupancy expenses increased by $24,000 and $37,000 for the three and nine months ended September 30, 2015, respectively, as compared to the same periods of 2014, which is primarily due to the rent expense and general overhead associated with the Tracy branch which opened in December 2014.

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

Income Taxes

We reported a provision for income taxes of $638,000 and $2,020,000 for the three and nine month periods ended September 30, 2015, respectively, representing decreases of $44,000 and $741,000 as compared to the provisions reported in the comparable periods of 2014. The effective income tax rate on income from continuing operations was 31.6% and 31.4% for the three and nine months ended September 30, 2015, respectively, compared to 30.8% and 33.5% for the comparable periods of 2014. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). The disparity between the effective tax rates for 2015 as compared to 2014 is primarily due to tax credits from California Enterprise Zones and low income housing projects as well as tax free-income on loans within these enterprise zones and municipal securities and loans that comprise a larger proportion of pre-tax income in 2015 as compared to 2014.

Asset Quality

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

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

Non-accrual loans totaled $4.29 million at September 30, 2015, as compared to $4.70 million at December 31, 2014. The non-accrual loans as of September 30, 2015 are loans made to five borrowers primarily for purposes of commercial real estate. As of September 30, 2015, we had five loans considered troubled debt restructurings totaling $3.24 million, all of which are included in non-accrual loans.

OREO as of September 30, 2015 consisted of three properties, one of which was a residential land acquired through foreclosure that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. The other two OREO properties consisted of commercial real estate totaling $834,000 and were acquired through foreclosure.

The following table presents information about the Bank's non-performing assets, including asset quality ratios as of September 30, 2015 and December 31, 2014:

Non-Performing Assets

(in thousands)	**September 30, 2015**		**December 31, 2014**	
Loans in non-accrual status	$ 4,289		$ 4,700	
Loans past due 90 days or more and accruing	0		0	
Total non-performing loans	4,289		4,700	
Other real estate owned	834		884	
Total non-performing assets	$ 5,123		$ 5,584	
Allowance for loan losses	$ 7,389		$ 7,534	
Asset quality ratios:				
Non-performing assets to total assets	0.65	%	0.74	%
Non-performing loans to total loans	0.90	%	1.03	%
Allowance for loan losses to total loans	1.55	%	1.66	%
Allowance for loan losses to total non-performing loans	172.3	%	160.3	%

Non-performing assets decreased by $461,000 as of September 30, 2015, as compared to December 31, 2014, as a result of $1,439,000 in principal payments and charge-offs of $15,000. This was offset by two additional loans totaling $1,043,000 that were placed on non-accrual loans status during the first nine months of 2015. There was a fair value write down of $50,000 on an OREO property during the first nine months of 2015, leaving the balance at $834,000 as September 30, 2015, as the Company continued to hold the three properties mentioned above.

Allowance for Loan and Lease Losses ("ALLL")

Due to credit risk inherent in our lending business, we routinely set aside allowances through charges to earnings. Such charges are not only made for the outstanding loan portfolio, but also for off-balance sheet items, such as commitments to extend credits or letters of credit. Charges made for the outstanding loan portfolio have been credited to the allowance for loan losses, whereas charges for off-balance sheet items have been credited to the reserve for off-balance sheet items, which is presented as a component of other liabilities. The Company recorded no provisions during the three months ended September 30, 2015 and a reversal of $125,000 for the nine months ended September 30, 2015, as compared to no provisions in the three month period of 2014 and a reversal of loan loss provisions of $1,877,000 for the nine month period in 2014.

The allowance for loan losses decreased by $145,000 or 1.92%, to $7.39 million at September 30, 2015, as compared with $7.53 million at December 31, 2014. The Company recognized the decrease in the allowance for loan losses during the first nine months of the year due to the $125,000 reversal of loan loss provision as previously described, which was offset by net loan charge offs of $19,000. The decrease to the allowance for loan losses and increase in gross loans resulted in a decrease in the allowance for loan losses as a percentage of total loans to 1.55% at September 30, 2015, as compared to 1.66% at December 31, 2014.

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

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

Although management believes the allowance at September 30, 2015 was adequate to absorb probable losses from any known and inherent risks in the portfolio, no assurance can be given that the adverse effect of current and future economic conditions on our service areas, or other variables, will not result in increased losses in the loan portfolio in the future.

Investment Activities

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

Cash Equivalents

The Company holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of September 30, 2015, and December 31, 2014, we had $156.6 million and $144.3 million, respectively, in cash and cash equivalents.

Investment Securities

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

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

Deposits

Total deposits at September 30, 2015 were $712.6 million, a $43.0 million or 6.4% increase from the deposit total of $669.6 million at December 31, 2014. Average deposits increased $72.0 million to $682.4 million for the nine month period ended September 30, 2015 as compared to the same period in 2014. We attracted deposits due to the safety and soundness of the Bank and our focus on customer service.

Deposits Outstanding

(in thousands)	**September 30, 2015**	**December 31, 2014**	**Nine month change $**	**%**
Demand	$ 228,529	$ 225,957	$ 2,572	1.1 %
NOW	114,055	108,374	5,681	5.2 %
MMDA	271,171	247,442	23,729	9.6 %
Savings	50,508	39,412	11,096	28.2 %
Time < $250K	32,588	38,247	(5,659)	(14.8%)
Time > $250K	15,726	10,149	5,577	55.0 %
	$ 712,577	**$ 669,581**	**$ 42,996**	**6.4 %**

Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. Seven of our clients carry deposit balances of more than 1% of our total deposits, one of which had a deposit balance of more than 3% of total deposits at September 30, 2015.

Since our deposit growth strategy emphasizes core deposit growth we have avoided relying on brokered deposits as a consistent source of funds. The Company had $1.5 million and $1.8 million in brokered deposits as of September 30, 2015 and December 31, 2014, respectively. The only brokered deposits the Bank holds are from CDARS and ICS, a certificate of deposit and money market account program, respectively, that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer.

Borrowings

Although deposits are the primary source of funds for our lending and investment activities and for general business purposes, we may obtain advances from the Federal Home Loan Bank of San Francisco (“FHLB”) as an alternative to retail deposit funds. Our outstanding FHLB advances remained a zero balance at December 31, 2014 and September 30, 2015, as we continue to rely on deposit growth as our primary source of funding. See “Liquidity Management” below for the details on the FHLB borrowings program.

Capital Ratios

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

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

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

In July 2013, the U.S. banking agencies approved the U.S. version of Basel III. The federal bank regulatory agencies adopted version of Basel III revises the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to make them consistent with Basel III and to meet the requirements of the Dodd-Frank Act. Although many of the rules contained in these final regulations are applicable only to large, internationally active banks, some of them will apply on a phased in basis to all banking organizations, including the Company and the Bank. Among other things, the rules establish a new minimum common equity Tier 1 ratio (4.5% of risk-weighted assets), a higher minimum Tier 1 risk-based capital requirement (6.0% of risk-weighted assets) and a minimum non-risk-based leverage ratio (4.00% eliminating a 3.00% exception for higher rated banks). The new additional capital conservation buffer of 2.5% of risk weighted assets over each of the required capital ratios will be phased in from 2016 to 2019 and must be met to avoid limitations on the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The additional "countercyclical capital buffer" is also required for larger and more complex institutions. The new rules assign higher risk weighting to exposures that are more than 90 days past due or are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also change the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing rights and certain deferred tax assets and include unrealized gains and losses on available for sale debt and equity securities (with a one-time opt out option for Standardized Banks (banks with less than $250 billion of total consolidated assets and less than $10 billion of foreign exposures)). The rules, including alternative requirements for smaller community financial institutions like the Company, would be phased in through 2019. The implementation of the Basel III framework for the Company and the Bank commenced on January 1, 2015.

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

The following table shows our capital ratios, as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to qualify as a "well-capitalized" institution at September 30, 2015 and December 31, 2014:

(in thousands)	**Actual**		**For capital adequacy purposes**		**To be well capitalized under prompt corrective action provisions**	
Capital ratios for Bank:	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of September 30, 2015						
Total capital (to Risk- Weighted Assets)	$82,728	14.1 %	$47,102	≥8.0%	$58,878	≥10.0%

Tier I capital (to Risk- Weighted Assets)	$75,365	12.8 %	$35,327	≥6.0%	$47,102	≥8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$75,365	12.8 %	$26,495	≥4.5%	$38,271	≥6.5%
Tier I capital (to Average Assets)	$75,365	9.7 %	$31,182	≥4.0%	$38,977	≥5.0%
As of December 31, 2014						
Total capital (to Risk- Weighted Assets)	$79,168	14.5 %	$43,778	≥8.0%	$54,722	≥10.0%
Tier I capital (to Risk- Weighted Assets)	$72,316	13.2 %	$21,889	≥4.0%	$32,833	≥6.0%
Tier I capital (to Average Assets)	$72,316	10.1 %	$28,783	≥4.0%	$35,979	≥5.0%

Capital ratios for Bancorp:

As of September 30, 2015						
Total capital (to Risk- Weighted Assets)	$83,323	14.2 %	$47,109	≥8.0%	N/A	N/A
Tier I capital (to Risk- Weighted Assets)	$75,959	12.9 %	$35,332	≥6.0%	N/A	N/A
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$75,959	12.9 %				