# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-Q

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

**For the quarterly period ended September 30, 2012**

**OR**

**o 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 x No o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 **o** | Accelerated filer **o** |
| Non-accelerated filer **o**<br>(Do not check if a smaller reporting company) | Smaller reporting company **x** |

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

**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: 7,907,780 shares of common stock outstanding as of October 31, 2012.

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**Oak Valley Bancorp**

**September 30, 2012**

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**PART I FINANCIAL STATEMENTS**

**Item 1. Consolidated Financial Statements (Unaudited)**

**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**AT SEPTEMBER 30, 2012 (UNAUDITED) AND DECEMBER 31, 2011 (AUDITED)**

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 93,642,262 | $ 73,189,775 |
| Federal funds sold | 13,770,000 | 27,895,000 |
| Cash and cash equivalents | 107,412,262 | 101,084,775 |
| Securities available for sale | 106,331,946 | 89,694,859 |
| Loans, net of allowance for loan loss of $7,953,477 and $8,609,174 at September 30, 2012 and December 31, 2011, respectively | 380,207,925 | 386,958,076 |
| Bank premises and equipment, net | 13,104,229 | 13,499,285 |
| Other real estate owned | 0 | 244,375 |
| Interest receivable and other assets | 20,760,514 | 20,690,288 |
| | $ 627,816,876 | $ 612,171,658 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Deposits | $ 553,333,461 | $ 536,204,003 |
| Federal Home Loan Bank advances | 0 | 3,000,000 |
| Interest payable and other liabilities | 5,658,634 | 2,565,649 |
| Total liabilities | 558,992,095 | 541,769,652 |
| Commitments and contingencies | | |
| Shareholders equity | | |
| Series B Preferred stock, no par value; $1,000 per share liquidation preference, 10,000,000 shares authorized, 6,750 and 13,500 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 6,750,000 | 13,500,000 |
| Common stock, no par value; 50,000,000 shares authorized, 7,909,280 and 7,718,469 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 23,673,210 | 23,453,443 |
| Additional paid-in capital | 2,293,954 | 2,128,700 |
| Retained earnings | 32,553,953 | 28,629,757 |
| Accumulated other comprehensive income, net of tax | 3,553,664 | 2,690,106 |
| Total shareholders equity | 68,824,781 | 70,402,006 |

| | $ | 627,816,876 | $ | 612,171,658 |
| --- | --- | --- | --- | --- |

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

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**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

**FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND SEPTEMBER 30, 2011**

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | $ 5,633,389 | $ 5,887,031 | $ 16,934,021 | $ 17,751,393 |
| Interest on securities available for sale | 860,565 | 810,946 | 2,572,096 | 2,273,355 |
| Interest on federal funds sold | 6,568 | 4,101 | 16,192 | 30,923 |
| Interest on deposits with banks | 28,327 | 28,354 | 83,114 | 68,514 |
| Total interest income | 6,528,849 | 6,730,432 | 19,605,423 | 20,124,185 |
| | | | | |
| INTEREST EXPENSE | | | | |
| Deposits | 274,963 | 375,913 | 870,925 | 1,223,445 |
| FHLB advances | | 15,199 | 4,707 | 55,687 |
| Federal funds purchased | | 51 | | 51 |
| Total interest expense | 274,963 | 391,163 | 875,632 | 1,279,183 |
| | | | | |
| Net interest income | 6,253,886 | 6,339,269 | 18,729,791 | 18,845,002 |
| PROVISION FOR LOAN LOSSES | 300,000 | 300,000 | 900,000 | 1,200,000 |
| | | | | |
| Net interest income after provision for loan losses | 5,953,886 | 6,039,269 | 17,829,791 | 17,645,002 |
| | | | | |
| OTHER INCOME | | | | |
| Service charges on deposits | 287,101 | 306,081 | 868,677 | 846,217 |
| Earnings on cash surrender value of life insurance | 105,000 | 109,710 | 315,000 | 324,668 |
| Mortgage commissions | 63,792 | 37,080 | 171,579 | 63,900 |
| Other | 334,556 | 310,499 | 938,579 | 879,771 |
| Total non-interest income | 790,449 | 763,370 | 2,293,835 | 2,114,556 |
| | | | | |
| OTHER EXPENSES | | | | |
| Salaries and employee benefits | 2,462,468 | 2,356,589 | 7,552,214 | 7,069,980 |
| Occupancy expenses | 766,401 | 731,512 | 2,260,483 | 2,063,759 |
| Data processing fees | 282,347 | 253,438 | 838,211 | 751,965 |
| OREO expenses | | 8,497 | 18,358 | 358,776 |
| Regulatory assessments (FDIC & DFI) | 114,000 | 135,000 | 347,000 | 531,000 |
| Other operating expenses | 901,973 | 723,095 | 2,719,706 | 2,359,473 |
| Total non-interest expense | 4,527,189 | 4,208,131 | 13,735,972 | 13,134,953 |
| | | | | |
| Net income before provision for income taxes | 2,217,146 | 2,594,508 | 6,387,654 | 6,624,605 |
| | | | | |
| PROVISION FOR INCOME TAXES | 738,315 | 845,565 | 2,095,958 | 2,260,925 |
| NET INCOME | $ 1,478,831 | $ 1,748,943 | $ 4,291,696 | $ 4,363,680 |
| | | | | |
| Preferred stock dividends and accretion | 84,375 | 571,482 | 367,500 | 992,305 |
| NET INCOME AVAILABLE TO COMMON SHAREHOLDERS | $ 1,394,456 | $ 1,177,461 | $ 3,924,196 | $ 3,371,375 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| NET INCOME PER COMMON SHARE | $ | 0.18 | $ | 0.15 | $ | 0.51 | $ | 0.44 |
| NET INCOME PER DILUTED COMMON SHARE | $ | 0.18 | $ | 0.15 | $ | 0.51 | $ | 0.44 |

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

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**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

**FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND SEPTEMBER 30, 2011**

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | $ 1,478,831 | $ 1,748,943 | $ 4,291,696 | $ 4,363,680 |
| Available for sale securities: | | | | |
| Gross unrealized gain arising during the year | 671,119 | 1,544,605 | 1,537,797 | 2,713,729 |
| Reclassification adjustment for gains realized in net income | (35,406) | (27,611) | (70,410) | (66,435) |
| Income tax expense | (261,596) | (624,243) | (603,829) | (1,089,361) |
| Other comprehensive income | 374,117 | 892,751 | 863,558 | 1,557,933 |
| Comprehensive income | $ 1,852,948 | $ 2,641,694 | $ 5,155,254 | $ 5,921,613 |

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

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**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

**FOR THE YEAR ENDED DECEMBER 31, 2011 AND THE NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2012 (UNAUDITED)**

| | YEAR ENDED DECEMBER 31, 2011 AND NINE MONTHS ENDED SEPTEMBER 30, 2012 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Common Stock | | Preferred Stock | | Additional Paid-in | Retained | Accumulated Other Comprehensive | Total Shareholders |
| | Shares | Amount | Shares | Amount | Capital | Earnings | Income | Equity |
| Balances, January 1, 2011 | 7,702,127 | $ 24,003,549 | 13,500 | $ 13,013,945 | $ 2,080,218 | $ 24,016,466 | $ 1,543,554 | $ 64,657,732 |
| Stock options exercised | 3,037 | $ 9,894 | | | | | | $ 9,894 |
| Restricted stock issued | 13,305 | | | | | | | 0 |
| Repurchase of Series A preferred stock | | | (13,500) | $ (13,500,000) | | | | (13,500,000) |
| Series B preferred stock issued | | | 13,500 | 13,500,000 | | | | 13,500,000 |
| Preferred stock accretion | | | | 486,055 | | $ (486,055) | | 0 |
| Preferred stock dividend payments | | | | | | (761,249) | | (761,249) |
| Payment to repurchase U.S. Treasury Warrant | | (560,000) | | | | | | (560,000) |
| Stock based compensation | | | | | 48,482 | | | 48,482 |
| Other comprehensive income | | | | | | | 1,146,552 | 1,146,552 |
| Net income | | | | | | 5,860,595 | | 5,860,595 |
| Balances, December 31, 2011 | 7,718,469 | $ 23,453,443 | 13,500 | $ 13,500,000 | $ 2,128,700 | $ 28,629,757 | $ 2,690,106 | $ 70,402,006 |
| Stock options exercised | 54,436 | $ 219,767 | | | | | | $ 219,767 |
| Tax benefit on stock options exercised | | | | | 37,218 | | | 37,218 |
| Restricted stock issued | 136,375 | | | | | | | 0 |
| Repurchase of Series B preferred stock | | | (6,750) | $ (6,750,000) | | | | (6,750,000) |
| Preferred stock dividend payments | | | | | | (367,500) | | (367,500) |
| Stock based compensation | | | | | 128,036 | | | 128,036 |
| | | | | | | | 863,558 | 863,558 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Other comprehensive income | | | | | | | | |
| Net income | | | | | | 4,291,696 | | 4,291,696 |
| Balances, September 30, 2012 | 7,909,280 | $ 23,673,210 | 6,750 | $ 6,750,000 | $ 2,293,954 | $ 32,553,953 | $ 3,553,664 | $ 68,824,781 |

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

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**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

**FOR THE NINE MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND SEPTEMBER 30, 2011**

| | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|
| | **2012** | **2011** |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 4,291,696 | $ 4,363,680 |
| Adjustments to reconcile net earnings to net cash from operating activities: | | |
| Provision for loan losses | 900,000 | 1,200,000 |
| Decrease in deferred fees/costs, net | (81,575) | (29,029) |
| Depreciation | 848,181 | 718,160 |
| Amortization (accretion) of investment securities, net | 166,228 | 20,452 |
| Stock based compensation | 128,036 | 40,918 |
| Excess tax benefits from stock-based payment arrangements | (37,218) | 0 |
| Gain on sale of premises and equipment | (22,498) | 0 |
| OREO write downs and (gain)/losses on sale | (3,548) | 290,609 |
| Gain on called available for sale securities | (70,410) | (66,435) |
| Earnings on cash surrender value of life insurance | (315,000) | (324,668) |
| Increase (decrease) in interest payable and other liabilities | 3,092,985 | (121,498) |
| Increase in interest receivable | (76,105) | (37,872) |
| (Increase) decrease in other assets | (644,782) | 2,434,927 |
| Net cash from operating activities | 8,175,990 | 8,489,244 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of available for sale securities | (40,439,977) | (44,129,366) |
| Proceeds from maturities, calls, and principal paydowns of securities available for sale | 25,174,459 | 13,290,950 |
| Net decrease in loans | 5,931,726 | 12,217,278 |
| Purchase of FRB Stock | (1,450) | 0 |
| Redemption of FHLB stock | 400,500 | 0 |
| Proceeds from sale of OREO | 247,923 | 243,190 |
| Proceeds from sales of premises and equipment | 22,498 | 0 |
| Net purchases of premises and equipment | (453,125) | (3,937,552) |
| Net cash (used in) investing activities | (9,117,446) | (22,315,500) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| FHLB payments | (3,000,000) | (2,000,000) |
| Repurchase of Series A Preferred Stock | 0 | (13,500,000) |
| Proceeds from Series B Preferred Stock issued | 0 | 13,500,000 |
| Preferred stock dividend payment | (367,500) | (498,750) |
| Payment to repurchase U.S. Treasury Warrant | 0 | (560,000) |
| Repurchase of Series B preferred stock | (6,750,000) | 0 |
| Net increase in demand deposits and savings accounts | 19,164,074 | 40,067,219 |
| Net decrease in time deposits | (2,034,616) | (11,300,944) |
| Excess tax benefits from stock-based payment arrangements | 37,218 | 0 |
| Proceeds from sale of common stock and exercise of stock options | 219,767 | 9,894 |
| Net cash from financing activities | 7,268,943 | 25,717,419 |
| | | |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 6,327,487 | 11,891,163 |

| | | | | |
|---|---|---|---|---|
| CASH AND CASH EQUIVALENTS, beginning of period | | 101,084,775 | | 68,936,916 |
| | | | | |
| CASH AND CASH EQUIVALENTS, end of period | $ | 107,412,262 | $ | 80,828,079 |
| | | | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | | | |
| Cash paid during the period for: | | | | |
| Interest | $ | 931,745 | $ | 1,310,802 |
| Income taxes | $ | 965,000 | $ | 3,136,119 |
| | | | | |
| NON-CASH INVESTING ACTIVITIES: | | | | |
| Real estate acquired through foreclosure | $ | 0 | $ | 0 |
| Change in unrealized gain on available-for-sale securities | $ | 1,467,387 | $ | 2,647,293 |
| | | | | |
| NON-CASH FINANCING ACTIVITIES: | | | | |
| Accretion of preferred stock | $ | 0 | $ | 486,055 |

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

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**OAK VALLEY BANCORP**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## NOTE 1 BASIS OF PRESENTATION

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

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America (GAAP) and with general practices within the banking industry. In preparing financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the estimation of compensation expense related to stock options granted to employees and directors, and valuation allowances associated with deferred tax assets, the recognition of which are based on future taxable income.

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, 2012 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. 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, 2011.

## NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS

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

In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income* (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders equity. Any adjustments for items are that reclassified from other comprehensive income to net income are to be presented on the face of the entities financial statement regardless the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years, and interim periods beginning on or after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. The ASU defers indefinitely the requirement to present reclassification adjustments and the effect of those reclassification adjustments on the face of the financial statements where net income is presented, by component of net income, and on the face of the financial statements where other comprehensive income is presented, by component of other comprehensive income. The adoption of the ASUs did not have a material impact on the Company s consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, *Disclosures about Offsetting Assets and Liabilities.* The update requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally enforceable right of setoff and intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to

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enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company s consolidated financial statements.

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

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

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

**NOTE 4 SECURITIES**

The amortized cost and estimated fair values of debt securities as of September 30, 2012 are as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| U.S. agencies | $ 54,091,795 | 3,505,754 | $ (43,347) | $ 57,554,202 |
| Collateralized mortgage obligations | 12,198,316 | 936,922 | | 13,135,238 |
| Municipalities | 25,299,589 | 1,737,920 | (61,153) | 26,976,356 |
| SBA Pools | 1,192,805 | 46 | (31) | 1,192,820 |
| Corporate debt | 4,662,535 | 43,739 | (102,802) | 4,603,472 |
| Mutual Fund | 2,847,922 | 25,000 | (3,064) | 2,869,858 |
| | $ 100,292,962 | $ 6,249,381 | $ (210,397) | $ 106,331,946 |

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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, 2012.

| | 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 | $ 2,949,917 | $ (43,347) | $ | | $ 2,949,917 | $ (43,347) |
| Collateralized mortgage obligations | | | | | | |
| Municipalities | 3,405,674 | (61,153) | | | 3,405,674 | (61,153) |
| SBA Pools | 298,648 | (31) | | | 298,648 | (31) |
| Corporate debt | 748,515 | (1,485) | 1,898,684 | (101,317) | 2,647,199 | (102,802) |
| Mutual Fund | | | 996,936 | (3,064) | 996,936 | (3,064) |
| Total temporarily impaired securities | $ 7,402,754 | $ (106,016) | $ 2,895,620 | $ (104,381) | $ 10,298,374 | $ (210,397) |

At September 30, 2012, there was one corporate debt security and one mutual fund in an unrealized loss position for greater than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary.  This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security s fair value.Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Bank does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The amortized cost and estimated fair value of debt securities at September 30, 2012, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | **Amortized Cost** | **Fair Value** |
|---|---|---|
| Available-for-sale securities: | | |
| Due in one year or less | $ 8,091,271 | $ 8,089,652 |
| Due after one year through five years | 17,351,268 | 18,855,005 |
| Due after five years through ten years | 24,972,034 | 26,901,661 |
| Due after ten years | 49,878,389 | 52,485,628 |
| | $ 100,292,962 | $ 106,331,946 |

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

| | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Market Value** |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| U.S. agencies | $ 52,101,177 | 2,722,817 | $ (14,686) | $ 54,809,308 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Collateralized mortgage obligations | | 11,366,368 | | 728,104 | | | | 12,094,472 |
| Municipalities | | 15,660,035 | | 1,312,377 | | (370) | | 16,972,042 |
| SBA Pools | | 1,236,366 | | 55 | | | | 1,236,421 |
| Corporate debt | | 2,000,000 | | 0 | | (185,716) | | 1,814,284 |
| Mutual Fund | | 2,759,316 | | 17,188 | | (8,172) | | 2,768,332 |
| | $ | 85,123,262 | $ | 4,780,541 | $ | (208,944) | $ | 89,694,859 |

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

| | 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 | $ 2,985,314 | $ (14,686) | $ | | $ 2,985,314 | $ (14,686) |
| Collateralized mortgage obligations | | | | | | |
| Municipalities | 561,580 | (370) | | | 561,580 | (370) |
| SBA Pools | | | | | | |
| Corporate debt | 1,814,284 | (185,716) | | | 1,814,284 | (185,716) |
| Mutual Fund | 991,828 | (8,172) | | | 991,828 | (8,172) |
| Total temporarily impaired securities | $ 6,353,006 | $ (208,944) | $ | $ | $ 6,353,006 | $ (208,944) |

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

We recognized a gain of $35,406 and $70,410 for the three and nine month periods ended September 30, 2012, respectively, on certain available-for-sale securities that were partially called, which compares to $27,611 and $66,435 in the same periods of 2011. There were no sales of available-for-sale securities during the first nine months of 2012 and 2011.

Securities carried at $47,394,729 and $53,419,019 at September 30, 2012 and December 31, 2011, respectively, were pledged to secure deposits of public funds.

**NOTE 5 LOANS**

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of September 30, 2012, approximately 82% of the Bank s loans are commercial real estate loans which include construction loans. Approximately 9% of the Bank s loans are for general commercial uses including professional, retail, and small business. Additionally, 7% of the Company s loans are for residential real estate and other consumer loans. The remaining 2% are agriculture loans. Loan totals were as follows:

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate- construction | $ 3,175,694 | $ 14,595,324 |

| | | | | |
|---|---|---|---|---|
| Commercial real estate- mortgages | | 278,881,249 | | 284,263,685 |
| Land | | 15,442,791 | | 10,635,954 |
| Farmland | | 21,491,290 | | 20,549,849 |
| Commercial and industrial | | 35,229,400 | | 32,017,744 |
| Consumer | | 1,090,601 | | 1,212,986 |
| Consumer residential | | 26,793,244 | | 23,870,519 |
| Agriculture | | 6,609,991 | | 9,055,622 |
| Total loans | | 388,714,260 | | 396,201,683 |
| | | | | |
| Less: | | | | |
| Deferred loan fees and costs, net | | (552,858) | | (634,433) |
| Allowance for loan losses | | (7,953,477) | | (8,609,174) |
| Net loans | $ | 380,207,925 | $ | 386,958,076 |

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*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 Bank avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Bank 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, 2012, commercial real estate loans equal to approximately 37.1% 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 Bank may originate from time to time, the Bank generally requires the borrower to have had an existing relationship with the Bank and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

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

other specified credit and documentation requirements.

The Bank 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.

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*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:

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate- construction | $ 113,552 | $ 179,262 |
| Commercial real estate- mortgages | 2,958,438 | 3,671,693 |
| Land | 2,492,671 | 3,277,463 |
| Farmland | 0 | 0 |
| Commercial and industrial | 22,111 | 104,481 |
| Consumer | 0 | 0 |
| Consumer residential | 1,024,468 | 0 |
| Agriculture | 0 | 0 |
| Total non-accrual loans | $ 6,611,240 | $ 7,232,899 |

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately $178,000 and $514,000 in three and nine month periods ended September 30, 2012, respectively, as compared to $168,000 and $692,000 in the same periods of 2011.

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, 2012:

| | 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 |
|---|---|---|---|---|---|---|---|
| **September 30, 2012** | | | | | | | |
| Commercial real estate: | | | | | | | |
| Commercial R.E. - construction | $ 0 | $ 0 | $ 113,550 | $ 113,550 | $ 3,062,144 | $ 3,175,694 | $ 0 |
| Commercial R.E. - mortgages | 0 | 301,201 | 2,322,604 | 2,623,805 | 276,257,444 | 278,881,249 | 0 |
| Land | 669,232 | 2,902,031 | 1,769,013 | 5,340,276 | 10,102,515 | 15,442,791 | 0 |
| Farmland | 0 | 0 | 0 | 0 | 21,491,290 | 21,491,290 | 0 |
| Commercial and industrial | 0 | 363,465 | 0 | 363,465 | 34,865,935 | 35,229,400 | 0 |
| Consumer | 0 | 0 | 0 | 0 | 1,090,601 | 1,090,601 | 0 |
| Consumer residential | 164,583 | 122,922 | 859,886 | 1,147,391 | 25,645,853 | 26,793,244 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 6,609,991 | 6,609,991 | 0 |

| Total | $ 833,815 | $ 3,689,619 | $ 5,065,053 | $ 9,588,487 | $ 379,125,773 | $ 388,714,260 | $ 0 |
|---|---|---|---|---|---|---|---|

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

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

*Impaired Loans.* Loans are considered impaired when, based on current information and events, it is probable the Bank 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, 2012 and 2011. Average recorded investment in impaired loans was $6,898,000 and $6,727,000 for the three and nine months ended September 30, 2012, respectively, as compared to $8,752,000 and $8,918,000 for the same periods of 2011. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

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Impaired loans as of September 30, 2012 and December 31, 2011 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired.

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment |
|---|---|---|---|---|---|---|
| **September 30, 2012** | | | | | | |
| Commercial real estate: | | | | | | |
| Commercial R.E. - construction | $ 180,153 | $ 0 | $ 113,552 | $ 113,552 | $ 3,726 | $ 257,012 |
| Commercial R.E. - mortgages | 5,119,027 | 2,567,598 | 390,840 | 2,958,438 | 50,109 | 3,074,108 |
| Land | 6,904,582 | 669,232 | 1,823,439 | 2,492,671 | 440,151 | 2,959,017 |
| Farmland | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial and Industrial | 28,003 | 22,111 | 0 | 22,111 | 0 | 63,193 |
| Consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer residential | 1,037,183 | 1,024,468 | 0 | 1,024,468 | 0 | 373,526 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | $ 13,268,948 | $ 4,283,409 | $ 2,327,831 | $ 6,611,240 | $ 493,986 | $ 6,726,856 |
| | | | | | | |
| **December 31, 2011** | | | | | | |
| Commercial real estate: | | | | | | |
| Commercial R.E. - construction | $ 245,862 | $ 0 | $ 179,262 | $ 179,262 | $ 5,984 | $ 1,177,407 |
| Commercial R.E. - mortgages | 4,469,681 | 3,671,693 | 0 | 3,671,693 | 0 | 4,111,549 |
| Land | 7,659,990 | 697,232 | 2,580,231 | 3,277,463 | 544,630 | 3,329,784 |
| Farmland | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial and Industrial | 116,867 | 104,481 | 0 | 104,481 | 0 | 36,655 |
| Consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | $ 12,492,400 | $ 4,473,406 | $ 2,759,493 | $ 7,232,899 | $ 550,614 | $ 8,655,395 |

*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 Bank s internal underwriting policy.

At September 30, 2012, there were 6 loans and leases that were considered to be troubled debt restructurings, all of which are considered nonaccrual totaling $2,628,000. At September 30, 2012 and December 31, 2011 there were unfunded commitments of $1,680,000 and $1,644,000, respectively, on one loan classified as a troubled debt restructure because of an agreement with a borrower to continue advancing funds and covering overhead costs on a residential development project. The Bank will receive proceeds to pay down the principal as the residential properties sell. We have allocated $148,000 and $551,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011, respectively.

During the three and nine month periods ended September 30, 2012, the terms of two loans were modified as troubled debt restructurings. 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.

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The following table presents loans by class modified as troubled debt restructurings that occurred during the three and nine month periods ended September 30, 2012:

| | Three Months Ended September 30, 2012 | | | Nine Months Ended September 30, 2012 | | |
|---|---|---|---|---|---|---|
| | 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 | 58,261 | 58,261 | 1 | 58,261 | 58,261 |
| Farmland | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial and Industrial | 1 | 28,180 | 28,180 | 1 | 28,180 | 28,180 |
| Consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | 2 | $ 86,441 | $ 86,441 | 2 | $ 86,441 | $ 86,441 |

The troubled debt restructuring during the three and nine months ended September 30, 2012 did not increase the allowance for loan losses as a result of loan modifications because the loans are evaluated as an impaired loan and a specific valuation allowance would have already been allocated, if necessary, prior to the loan modification.  There were no charge offs as a result of loan modifications, as the contractual balances outstanding were determined to be collectible.

The following table presents loans by class 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, 2012.

| | Three Months Ended September 30, 2012 | | Nine Months Ended September 30, 2012 | |
|---|---|---|---|---|
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment |
| Commercial real estate: | | | | |
| Commercial R.E. - construction | 0 | $ 0 | 1 | 113,552 |
| Commercial R.E. - mortgages | 0 | 0 | | |
| Land | 0 | 0 | 1 | 1,197,418 |
| Farmland | 0 | 0 | 0 | 0 |
| Commercial and Industrial | 0 | 0 | 0 | 0 |
| Consumer | 0 | 0 | 0 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 |
| Agriculture | 0 | 0 | 0 | 0 |
| Total | 0 | $ 0 | 2 | $ 1,310,970 |

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

The troubled debt restructuring that subsequently defaulted above did not result in an increase to the allowance for loan losses or a charge-off during the three and nine months ended September 30, 2012 because the loans are evaluated as an impaired loan and a specific valuation allowance would have already been allocated, if necessary, prior to the payment default and the contractual balances outstanding were determined to be collectible.

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

We grade loans using the following letter system:

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

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

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

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

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

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

•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.

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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.

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

| | September 30, 2012 Weighted Average Risk Grade | December 31, 2011 Weighted Average Risk Grade |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate - construction | 3.36 | 3.52 |
| Commercial real estate - mortgages | 3.22 | 3.26 |
| Land | 4.46 | 4.75 |
| Farmland | 3.18 | 3.40 |
| Commercial and Industrial | 3.18 | 3.21 |
| Consumer | 2.50 | 2.76 |
| Consumer residential | 3.18 | 3.10 |
| Agriculture | 3.41 | 3.23 |
| Total gross loans | 3.26 | 3.30 |

The following table presents risk grade totals by class of loans as of September 30, 2012 and December 31, 2011. Risk grades 1 through 4 have been aggregated in the Pass line.

| Dollars in thousands | Commercial R.E. Construction | Commercial R.E. Mortgages | Land | Farmland | Commercial and Industrial | Consumer | Consumer Residential | Agriculture | Total |
|---|---|---|---|---|---|---|---|---|---|
| September 30, 2012 | | | | | | | | | |
| Pass | $ 3,062,142 | $ 263,918,801 | $ 10,048,089 | $ 21,491,290 | $ 34,111,686 | $ 1,073,282 | $ 25,253,991 | $ 5,249,039 | $ 364,208,320 |
| Special mention | | 7,949,102 | | | 289,638 | | | | 8,238,740 |
| Substandard | 113,552 | 7,013,346 | 5,394,702 | | 828,076 | 17,319 | 1,539,253 | 1,360,952 | 16,267,200 |
| Doubtful | | | | | | | | | |
| Total loans | $ 3,175,694 | $ 278,881,249 | $ 15,442,791 | $ 21,491,290 | $ 35,229,400 | $ 1,090,601 | $ 26,793,244 | $ 6,609,991 | $ 388,714,260 |
| December 31, 2011 | | | | | | | | | |
| Pass | $ 14,416,062 | $ 264,913,517 | $ 4,419,659 | $ 19,188,322 | $ 31,000,530 | $ 1,179,624 | $ 23,475,447 | $ 8,357,801 | $ 366,950,962 |
| Special mention | | 8,684,736 | | | 78,011 | | | | 8,762,747 |
| Substandard | 179,262 | 10,665,432 | 6,216,295 | 1,361,527 | 939,203 | 16,943 | 395,072 | 697,821 | 20,471,555 |
| Doubtful | | | | | | 16,419 | | | 16,419 |
| Total loans | $ 14,595,324 | $ 284,263,685 | $ 10,635,954 | $ 20,549,849 | $ 32,017,744 | $ 1,212,986 | $ 23,870,519 | $ 9,055,622 | $ 396,201,683 |

*Allowance for Loan Losses.* The allowance for loan losses is a reserve established by the Bank 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

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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 Bank s control, including, among other things, the performance of the Bank 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.

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The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2012 and 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

**Allowance for Loan Losses**

**For the Three and Nine Months Ended September 30, 2012 and 2011**

| | Commercial Real Estate | Commercial and Industrial | Consumer | Consumer Residential | Agriculture | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **Three Months Ended September 30, 2012** | | | | | | | |
| Beginning balance | $ 6,657,657 | $ 409,740 | $ 52,872 | $ 506,991 | $ 225,235 | $ 155,453 | $ 8,007,948 |
| Charge-offs | (218,373) | 0 | (3,721) | (149,897) | 0 | 0 | (371,991) |
| Recoveries | 6,207 | 0 | 1,071 | 10,242 | 0 | 0 | 17,520 |
| Provision | 70,979 | 75,526 | 1,070 | 38,452 | 23,142 | 90,831 | 300,000 |
| Ending balance | $ 6,516,470 | $ 485,266 | $ 51,292 | $ 405,788 | $ 248,377 | $ 246,284 | $ 7,953,477 |
| **Nine Months Ended September 30, 2012** | | | | | | | |
| Beginning balance | $ 6,969,004 | $ 606,307 | $ 65,060 | $ 347,905 | $ 363,174 | $ 257,724 | $ 8,609,174 |
| Charge-offs | (1,428,713) | 0 | (24,372) | (149,897) | 0 | 0 | (1,602,982) |
| Recoveries | 29,200 | 926 | 3,311 | 13,848 | 0 | 0 | 47,285 |
| Provision | 946,979 | (121,967) | 7,293 | 193,932 | (114,797) | (11,440) | 900,000 |
| Ending balance | $ 6,516,470 | $ 485,266 | $ 51,292 | $ 405,788 | $ 248,377 | $ 246,284 | $ 7,953,477 |
| **Three Months Ended September 30, 2011** | | | | | | | |
| Beginning balance | $ 6,777,668 | $ 768,046 | $ 43,630 | $ 393,923 | $ 159,119 | $ 448,653 | $ 8,591,039 |
| Charge-offs | (29,001) | 0 | (1,296) | (38,078) | 0 | 0 | (68,375) |
| Recoveries | 28,581 | 4,707 | 1,240 | 230 | 0 | 0 | 34,758 |
| Provision | 125,007 | 37,876 | 21,482 | 16,731 | 118,746 | (19,842) | 300,000 |
| Ending balance | $ 6,902,255 | $ 810,629 | $ 65,056 | $ 372,806 | $ 277,865 | $ 428,811 | $ 8,857,422 |
| **Nine Months Ended September 30, 2011** | | | | | | | |
| Beginning balance | $ 6,577,011 | $ 686,303 | $ 61,115 | $ 375,349 | $ 152,526 | $ 402,625 | $ 8,254,929 |
| Charge-offs | (565,368) | (35,000) | (4,152) | (38,078) | 0 | 0 | (642,598) |
| Recoveries | 28,581 | 10,983 | 5,264 | 263 | 0 | 0 | 45,091 |
| Provision | 862,031 | 148,343 | 2,829 | 35,272 | 125,339 | 26,186 | 1,200,000 |
| Ending balance | $ 6,902,255 | $ 810,629 | $ 65,056 | $ 372,806 | $ 277,865 | $ 428,811 | $ 8,857,422 |

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The following table details the allowance for loan losses and ending gross loan balances as of September 30, 2012 and December 31, 2011, summarized by collective and individual evaluation methods of impairment.

| | Commercial Real Estate | Commercial and Industrial | Consumer | Consumer Residential | Agriculture | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **September 30, 2012** | | | | | | | |
| Allowance for loan losses for loans: | | | | | | | |
| Individually evaluated for impairment | $ 493,986 | $ 0 | $ 0 | $ | $ 0 | $ 0 | $ 493,986 |
| Collectively evaluated for impairment | 6,022,484 | 485,266 | 51,292 | 405,788 | 248,377 | 246,284 | 7,459,491 |
| | $ 6,516,470 | $ 485,266 | $ 51,292 | $ 405,788 | $ 248,377 | $ 246,284 | $ 7,953,477 |
| Ending gross loan balances: | | | | | | | |
| Individually evaluated for impairment | $ 5,564,661 | $ 22,111 | $ 0 | $ 1,024,468 | $ 0 | $ 0 | $ 6,611,240 |
| Collectively evaluated for impairment | 313,426,362 | 35,207,289 | 1,090,601 | 25,768,777 | 6,609,991 | 0 | 382,103,020 |
| | $ 318,991,023 | $ 35,229,400 | $ 1,090,601 | $ 26,793,245 | $ 6,609,991 | $ 0 | $ 388,714,260 |
| **December 31, 2011** | | | | | | | |
| Allowance for loan losses for loans: | | | | | | | |
| Individually evaluated for impairment | $ 550,614 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 550,614 |
| Collectively evaluated for impairment | 6,418,390 | 606,307 | 65,060 | 347,905 | 363,174 | 257,724 | 8,058,560 |
| | $ 6,969,004 | $ 606,307 | $ 65,060 | $ 347,905 | $ 363,174 | $ 257,724 | $ 8,609,174 |
| Ending balances of loans: | | | | | | | |
| Individually evaluated for impairment | $ 7,128,418 | $ 104,481 | $ 0 | $ 0 | $ 0 | $ 0 | $ 7,232,899 |
| Collectively evaluated for impairment | 322,916,394 | 31,913,263 | 1,212,986 | 23,870,519 | 9,055,622 | 0 | 388,968,784 |
| | $ 330,044,812 | $ 32,017,744 | $ 1,212,986 | $ 23,870,519 | $ 9,055,622 | $ 0 | $ 396,201,683 |

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Balance, beginning of period | $ 116,002 | $ 133,078 | $ 119,202 | $ 157,001 |
| Provision Recovery to Operations for Off Balance Sheet Commitments | (11,127) | (3,922) | (14,327) | (27,845) |
| Balance, end of period | $ 104,875 | $ 129,156 | $ 104,875 | $ 129,156 |

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, 2012 and December 31, 2011, loans carried at $388,714,260 and $396,201,683, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

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**NOTE 6 OTHER REAL ESTATE OWNED**

As of September 30, 2012, the Bank owned one property consisting of residential land that was written down to a zero balance that was classified as other real estate owned, as compared to two properties with outstanding balances of $244,375 as of December 31, 2011. Each of these properties was acquired through loan foreclosure. The residential land property the Bank owned at September 30, 2012 was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. There has been one sale of an OREO property which has reduced our OREO inventory from two properties as of December 31, 2011 to one property as of September 30, 2012. This OREO property sale was recorded in the first quarter of 2012 and resulted in a gain on sale of $4,000.

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 7 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.

During January 2008 the Bank awarded two of its directors a director retirement plan ( DRP ). Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The 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, 2012 and December 31, 2011 was $1,728,860 and $1,511,486, 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 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 other assets on the condensed consolidated balance sheet was $11,570,877 and $11,255,877 at September 30, 2012 and December 31, 2011, respectively.

**NOTE 8    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, 2012 and December 31, 2011. Such information, which pertains to the Company  s financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

Fair value measurements 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.

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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.

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

*Cash and cash equivalent* 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 2 valuation.

*Federal Home Loan Bank (FHLB) advances*   The fair value of FHLB advances is determined by the Company s internal assets and liabilities modeling system that accounts for various inputs such as maturities of specific advances and the current FHLB yield curve . Fair value on FHLB advances are considered a level 2 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.

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The estimated fair values of the Company s financial instruments at September 30, 2012 were as follows:

| | Carrying Amount | Fair Value | Hierarchy Valuation Level |
|---|---|---|---|
| **Financial assets:** | | | |
| Cash and cash equivalents | $ 107,412,262 | $ 107,412,262 | 1 |
| Restricted equity securities | 3,594,750 | 3,594,750 | 2 |
| Loans, net | 380,207,925 | 397,031,334 | 3 |
| Interest receivable | 1,779,562 | 1,779,562 | 2 |
| | | | |
| **Financial liabilities:** | | | |
| Deposits | (553,333,461) | (553,801,933) | 3 |
| Interest payable | (73,159) | (73,159) | 2 |
| | | | |
| **Off-balance-sheet assets (liabilities):** | | | |
| Commitments and standby letters of credit | | (401,002) | 3 |

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

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

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Assets and liabilities measured at fair value on a recurring and non-recurring basis as of September 30, 2012 and December 31, 2011 are summarized below:

| | | Fair Value Measurements at September 30, 2012 Using | | |
|---|---|---|---|---|
| | **September 30, 2012** | **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 | $ 57,554,202 | $ 0 | $ 57,554,202 | $ 0 |
| Collateralized mortgage obligations | 13,135,238 | 0 | 13,135,238 | 0 |
| Municipalities | 26,976,356 | 0 | 26,976,356 | 0 |
| SBA Pools | 1,192,820 | 0 | 1,192,820 | 0 |
| Corporate Debt | 4,603,472 | 0 | 4,603,472 | 0 |
| Mutual Fund | 2,869,858 | 2,869,858 | 0 | 0 |
| | | | | |
| Assets and liabilities measured on a non-recurring basis: | | | | |
| Impaired loans | $ 4,650,435 | $ 0 | $ 0 | $ 4,650,435 |

| | | Fair Value Measurements at December 31, 2011 Using | | |
|---|---|---|---|---|
| | **December 31, 2011** | **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 | $ 54,809,308 | $ 0 | $ 54,809,308 | $ 0 |
| Collateralized mortgage obligations | 12,094,472 | 0 | 12,094,472 | 0 |
| Municipalities | 16,972,042 | 0 | 16,972,042 | 0 |
| SBA Pools | 1,236,421 | 0 | 1,236,421 | 0 |
| Corporate debt | 1,814,284 | 0 | 1,814,284 | 0 |
| Mutual Fund | 2,768,332 | 2,768,332 | 0 | 0 |
| | | | | |
| Assets and liabilities measured on a non-recurring basis: | | | | |
| Impaired Loans | $ 4,650,738 | $ 0 | $ 0 | $ 4,650,738 |
| Other real estate owned | $ 244,375 | $ 0 | $ 0 | $ 244,375 |

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

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

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

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

**NOTE 9 EARNINGS PER SHARE**

Earnings per share (EPS) is calculated based on the weighted average common shares outstanding during the period. Basic EPS excludes dilution and is calculated by dividing net income available to common shareholders by the weighted average common shares outstanding. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

| | THREE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|
| **In thousands (except share and per share amounts)** | **2012** | **2011** |
| BASIC EARNINGS PER SHARE | | |
| Net income available to common shareholders | $ 1,394,456 | $ 1,177,461 |
| Weighted average shares outstanding | 7,750,727 | 7,705,164 |
| Net income per common share | $ 0.18 | $ 0.15 |

| DILUTED EARNINGS PER SHARE | | | | |
|---|---|---|---|---|
| Net income available to common shareholders | $ | 1,394,456 | $ | 1,177,461 |
| Weighted average shares outstanding | | 7,750,727 | | 7,705,164 |
| Effect of dilutive stock options | | 6,917 | | 15,636 |
| Effect of dilutive non-vested restricted shares | | 20,502 | | 10,663 |
| Weighted average shares of common stock and common stock equivalents | | 7,778,146 | | 7,731,463 |
| Net income per diluted common share | $ | 0.18 | $ | 0.15 |

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| In thousands (except share and per share amounts) | NINE MONTHS ENDED SEPTEMBER 30, 2012 | | 2011 | |
|---|---|---|---|---|
| BASIC EARNINGS PER SHARE | | | | |
| Net income available to common shareholders | $ | 3,924,196 | $ | 3,371,375 |
| Weighted average shares outstanding | | 7,733,848 | | 7,710,097 |
| Net income per common share | $ | 0.51 | $ | 0.44 |
| DILUTED EARNINGS PER SHARE | | | | |
| Net income available to common shareholders | $ | 3,924,196 | $ | 3,371,375 |
| Weighted average shares outstanding | | 7,733,848 | | 7,710,097 |
| Effect of dilutive stock options | | 11,934 | | 12,301 |
| Effect of dilutive non-vested restricted shares | | 11,972 | | 9,252 |
| Effect of dilutive warrants | | 0 | | 7,939 |
| Weighted average shares of common stock and common stock equivalents | | 7,757,754 | | 7,739,589 |
| Net income per diluted common share | $ | 0.51 | $ | 0.44 |

During the three and nine month periods ended September 30, 2012, anti-dilutive weighted average options to purchase 202,750 and 208,375 shares of common stock, respectively, were outstanding with prices ranging from $7.04 to $15.67.  Anti-dilutive weighted average stock options of 221,741 and 219,625 were outstanding during the three and nine month periods of 2011, respectively, with prices ranging from $5.74 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 2013.

Weighted average warrants of 350,346 issued to the U.S. Treasury Capital Purchase Program were dilutive for the nine month period ended September 30, 2011, as the exercise price of $5.78 was less than the average market price of common shares.  These warrants were not outstanding in the first nine months of 2012 as they were redeemed in August 2011.

During the three and nine month periods ended September 30, 2012, anti-dilutive non-vested restricted stock grants of 1,435 and 482 weighted average shares of common stock, respectively, were outstanding. These shares were anti-dilutive because the fair value of the grant was higher than the average market price of the common shares.

**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 2011 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*

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*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:*

*Asset Impairment Judgments*

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

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

*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.

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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 nonaccrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due.

*Stock-Based Compensation*

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

*Other Real Estate Owned*

Other real estate owned, which represents real estate acquired through foreclosure, or deed in lieu of foreclosure in satisfaction of commercial and real estate loans, is carried at the lower of cost or estimated fair value less the estimated selling costs of the real estate.

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The fair value of the property is based upon a current appraisal. The difference between the fair value of the real estate collateral and the loan balance at the time of transfer is recorded as a loan charge off if fair value is lower. Subsequent to foreclosure, management periodically performs valuations and the OREO property is carried at the lower of carrying value or fair value, less costs to sell. The determination of a property s estimated fair value incorporates (1) revenues projected to be realized from disposal of the property, (2) construction and renovation costs, (3) marketing and transaction costs, and (4) holding costs (e.g., property taxes, insurance and homeowners association dues). 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.

**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, 2012:

• Thanks to our deep roots in the communities that we serve, our focus on customer care and our selectivity in lending, during the first nine months of 2012, our performance has been better than most institutions of our size that compete in our market. Despite the stagnant economy affecting our primary market areas, we have been able to increase our core deposits to $540.8 million and have posted net income available to common shareholders of $0.18 and $0.51 per diluted share for the three and nine month periods ended September 30, 2012, respectively. While recently published economic data indicate that the current downturn may be easing, it is not clear when or at what speed the recession will end. To the extent that the recession continues, it will affect the market areas that we serve and our results accordingly.

• The Company recognized net income available to common shareholders of $1,394,000 and $3,924,000 for the three and nine month periods ended September 30, 2012, respectively, as compared to $1,177,000 and $3,371,000 for the same periods in 2011. The Company recognized net income before preferred stock dividends and accretion of $1,479,000 and $4,292,000 for the three and nine months ended September 30, 2012, respectively, as compared to $1,749,000 and $4,364,000 for the same periods in 2011. The factors contributing to these results will be discussed below.

• The Company recognized $84,000 and $368,000 in the third quarter and nine month period ended September 30, 2012, respectively, associated with the accrual for preferred stock dividends for the Series B Preferred Stock that the U.S. Treasury owns under the Small Business Lending Fund ( SBLF ). The Company repurchased 6,750 Series B Preferred Stock in May 2012 and thus had 6,750 shares outstanding at September 30, 2012. So long as such preferred stock remains outstanding under SBLF, it will pay quarterly cumulative dividends at a variable rate between 1% and 5% per year for the first 2.5 years depending on growth of our small business loan portfolio. If there is no loan growth after 2.5 years, the dividend rate could increase to 7% and if the preferred stock remains outstanding after 4.5 years, the rate increases to 9%, regardless of loan growth. In comparison, the three and nine month periods of 2011 reflected $169,000 and $506,000, respectively, for preferred

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stock dividends but also included preferred stock accretion of $403,000 and $487,000 as the original series A preferred stock were issued under the TARP program at a discount. The Company converted out of the TARP program and into the Small Business Lending Funding ( SBLF ) program in August 2011, which resulted in preferred stock discount accretion of $389,000 in the third quarter of 2011, the full remaining balance of the discount.

- The Company has taken significant steps to reduce the risk of loan losses. In the three and nine month periods ended September 30, 2012, the provision for loan loss was $300,000 and $900,000, respectively, which was flat for the third quarter and decreased by $300,000 year-to-date, compared to the same periods in 2011. The decrease was mainly due to management s assessment of the appropriate level for the allowance for loan losses and a decrease in the level of non-accrual loans. The Company continues to monitor the Bank s loan portfolio with the objective of avoiding defaults or write-downs. Despite these actions, the possibility of additional losses cannot be eliminated, but the Board of Directors and all employees continue to work hard to make the best of these continuing challenging conditions.

- Net interest income decreased $85,000 or 1.3% and $115,000 or 0.6% for the three and nine month periods ended September 30, 2012, respectively, compared to the same periods in 2011. The decrease was primarily due to loan and investment security yield reduction.

- Non-interest income increased by $27,000 or 3.5% and $179,000 or 8.5% for the three and nine months ended September 30, 2012, as compared to the same periods in 2011. The increase was primarily due to gains in mortgage commissions as well as an operating recovery of $120,000 posted in the first quarter of 2012 as described below.

- Non-interest expense increased by $319,000 or 7.6% and $601,000 or 4.6% for the three and nine month periods ended September 30, 2012, respectively, as compared to the same periods in 2011. The primary reason for the increase was an increase in salaries and benefits and occupancy associated with new branch openings in mid-2011, which was offset in part by the reduction in the write downs of OREO property values as described below.

- Total assets increased $15.6 million or 2.6% from December 31, 2011. Total net loans decreased by $6.8 million or 1.7% and investment securities increased by $16.6 million or 18.5% from December 31, 2011 to September 30, 2012, while deposits increased by $17.1 million or 3.2% for the same period.

**Income Summary**

For the three and nine month periods ended September 30, 2012, the Company recorded net income available to common shareholders of $1,394,000 and $3,924,000, respectively, representing increases of $217,000 and $553,000, as compared to the same periods in 2011. Return on average assets (annualized) was 0.97% and 0.96% for the three and nine months ended September 30, 2012, respectively, as compared with 1.21% and 1.03% for the same periods in 2011. Annualized return on average common equity was 9.02% and 8.78% for the three and nine months ended September 30, 2012, respectively, as compared to 8.44% and 8.43% for the same periods of 2011.

Net income before provisions for income taxes and preferred stock dividends and accretion was down $377,000 and $237,000 for the third quarter and nine months ended September 30, 2012, respectively, from the comparable 2011 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, 2012** | **Effect on Pre-Tax Income Increase (Decrease) Nine Months Ended September 30, 2012** |
|---|---|---|
| Change from 2011 to 2012 in: | | |
| Net interest income | $ (85) | $ (115) |
| Provision for loan losses | 0 | 300 |
| Non-interest income | 27 | 179 |
| Non-interest expense | (319) | (601) |
| Change in income before income taxes | $ (377) | $ (237) |

These variances will be explained in the discussion below.

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**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, 2012, net interest income was $6.25 million and $18.73 million, respectively, which represented decreases of $85,000 or 1.3% and $115,000 or 0.2% from the comparable periods in 2012.

The net interest margin (net interest income as a percentage of average interest earning assets) was 4.57% and 4.66% for the three and nine month periods ended September 30, 2012, respectively, a decrease of 28 and 22 basis points, as compared to the same periods in 2011. The decrease in the net interest margin in the first nine months of 2012 was primarily attributable to a change in the mix of earning assets with a higher portion in investment securities and interest earning deposits in bank balances, which had balance increases of $26.7 million and $6.6 million, respectively, compared to the first nine months of 2011. These balances had yields of 3.85% and 0.25%, respectively, in the first nine months of 2012, which was significantly less than the yield on gross loans and thus driving down the overall yield on earning assets.

The current low market interest rate environment has had a positive impact on net interest income in previous years because the Company s balance sheet is liability sensitive which typically results in our average cost of funds decreasing faster than the average yield on interest earning assets in a declining rate environment. In 2012, we have not recognized this benefit to the same degree, as deposit interest rates are at historic lows and have essentially reached a threshold in which they cannot reasonably be further reduced. However, the total cost of funds did recognize a moderate decrease of 12 and 14 basis points for the three and nine months ended September 30, 2012, respectively, compared to 2011 due to further rate reductions and a shift from high cost CDs and FHLB borrowed funds into demand deposit and money market accounts. In addition, average non-interest-bearing demand deposit balances increased by $29.5 million and $25.2 million for the three and nine month periods ended September 30, 2012, respectively, as compared to the same periods of 2011. Compared to cost of funds, the decrease in earning asset yield was more significant at 38 and 34 basis points for the three and nine month periods ended September 30, 2012, respectively, compared to the same periods of 2011. The investment securities portfolio recognized the most significant decrease of 57 and 74 basis points for the third quarter and nine month period of 2012, respectively, as compared to 2011, mainly because of the Company deploying cash into investment security purchases, which have historically low yields. The yield on loans has remained more stable, with a reduction of 25 and 26 basis points for the third quarter and nine month period of 2012, respectively, as compared to 2011, partly as a result of the significant portion of our loans that are at their contractual rate floors.

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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, 2012 and 2011:

***Net Interest Analysis***

| | Three Months Ended September 30, 2012 | | | Three Months Ended September 30, 2011 | | |
|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Average Balance** | **Interest Income / Expense** | **Avg Rate/ Yield** | **Average Balance** | **Interest Income / Expense** | **Avg Rate/ Yield** |
| **Assets:** | | | | | | |
| Earning assets: | | | | | | |
| Gross loans (1) (2) | $ 389,868 | $ 5,636 | 5.74% | $ 390,329 | $ 5,889 | 5.99% |
| Investment securities (2) | 102,847 | 967 | 3.73% | 81,806 | 886 | 4.30% |
| Federal funds sold | 11,174 | 7 | 0.25% | 6,978 | 4 | 0.23% |
| Interest-earning deposits | 48,105 | 28 | 0.23% | 45,655 | 28 | 0.24% |
| Total interest-earning assets | 551,994 | 6,638 | 4.77% | 524,768 | 6,807 | 5.15% |
| Total noninterest earning assets | 54,078 | | | 50,172 | | |
| Total Assets | 606,072 | | | 574,940 | | |
| **Liabilities and Shareholders Equity:** | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-earning DDA | 232 | | 0.00% | | | 0.00% |
| Money market deposits | 247,865 | 124 | 0.20% | 247,621 | 181 | 0.29% |
| NOW deposits | 67,428 | 27 | 0.16% | 66,296 | 32 | 0.19% |
| Savings deposits | 27,189 | 15 | 0.22% | 17,739 | 14 | 0.31% |
| Time certificates of deposit $100,000 or more | 37,563 | 80 | 0.84% | 39,202 | 96 | 0.97% |
| Other time deposits | 20,988 | 29 | 0.55% | 22,611 | 53 | 0.93% |
| Other borrowings | 0 | 0 | 0.00% | 6,019 | 15 | 0.99% |
| Total interest-bearing liabilities | 401,265 | 275 | 0.27% | 399,488 | 391 | 0.39% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing deposits | 133,457 | | | 103,958 | | |
| Other liabilities | 3,282 | | | 2,656 | | |
| Total noninterest-bearing liabilities | 136,739 | | | 106,614 | | |
| Shareholders equity | 68,068 | | | 68,838 | | |
| Total liabilities and shareholders equity | $ 606,072 | | | $ 574,940 | | |
| Net interest income | | $ 6,363 | | | $ 6,416 | |
| Net interest spread (3) | | | 4.50% | | | 4.76% |
| Net interest margin (4) | | | 4.57% | | | 4.85% |

*(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.

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| (Dollars in thousands) | Average Balance | Nine months ended September 30, 2012 Interest Income / Expense | Avg Rate/ Yield | Average Balance | Nine months ended September 30, 2011 Interest Income / Expense | Avg Rate/ Yield |
|---|---|---|---|---|---|---|
| **Assets:** | | | | | | |
| Earning assets: | | | | | | |
| Gross loans (1) (2) | $ 391,036 | $ 16,943 | 5.77% | $ 394,011 | $ 17,758 | 6.03% |
| Investment securities (2) | 99,065 | 2,864 | 3.85% | 72,354 | 2,486 | 4.59% |
| Federal funds sold | 9,453 | 16 | 0.23% | 17,729 | 31 | 0.23% |
| Interest-earning deposits | 44,919 | 83 | 0.25% | 38,321 | 69 | 0.24% |
| Total interest-earning assets | 544,473 | 19,906 | 4.87% | 522,415 | 20,344 | 5.21% |
| Total noninterest earning assets | 53,385 | | | 42,968 | | |
| Total Assets | 597,858 | | | 565,383 | | |
| **Liabilities and Shareholders Equity:** | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-earning DDA | 106 | | 0.00% | | | 0.00% |
| Money market deposits | 250,649 | 401 | 0.21% | 241,497 | 594 | 0.33% |
| NOW deposits | 65,765 | 78 | 0.16% | 65,520 | 100 | 0.20% |
| Savings deposits | 25,832 | 45 | 0.23% | 18,487 | 52 | 0.38% |
| Time certificates of deposit $100,000 or more | 37,125 | 244 | 0.88% | 41,058 | 305 | 0.99% |
| Other time deposits | 22,093 | 103 | 0.62% | 23,952 | 172 | 0.96% |
| Other borrowings | 624 | 5 | 1.07% | 7,025 | 56 | 1.07% |
| Total interest-bearing liabilities | 402,194 | 876 | 0.29% | 397,539 | 1,279 | 0.43% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing deposits | 123,300 | | | 98,015 | | |
| Other liabilities | 3,018 | | | 2,863 | | |
| Total noninterest-bearing liabilities | 126,318 | | | 100,878 | | |
| Shareholders equity | 69,346 | | | 66,966 | | |
| Total liabilities and shareholders equity | $ 597,858 | | | $ 565,383 | | |
| Net interest income | | $ 19,030 | | | $ 19,065 | |
| Net interest spread (3) | | | 4.58% | | | 4.78% |
| Net interest margin (4) | | | 4.66% | | | 4.88% |

*(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.

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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, 2012 and 2011. 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)*

| | For the Three Months Ended September 30, 2012 vs 2011 Increase (Decrease) in interest income and expense due to changes in: | | |
|---|---|---|---|
| | **Volume** | **Rate** | **Total** |
| **Interest income:** | | | |
| Gross loans (1) (2) | $ (7) | $ (246) | $ (253) |
| Investment securities (2) | 228 | (147) | 81 |
| Federal funds sold | 2 | 1 | 3 |
| Interest-earning deposits | 2 | (2) | 0 |
| **Total interest income** | **$ 225** | **$ (394)** | **$ (169)** |
| | | | |
| **Interest expense:** | | | |
| Interest-earning DDA | 0 | 0 | 0 |
| Money market deposits | 0 | (57) | (57) |
| NOW deposits | 1 | (6) | (5) |
| Savings deposits | 7 | (6) | 1 |
| Time CD $100K or more | (4) | (12) | (16) |
| Other time deposits | (4) | (20) | (24) |
| Other borrowings | (15) | 0 | (15) |
| **Total interest expense** | **$ (15)** | **$ (101)** | **$ (116)** |
| | | | |
| **Change in net interest income** | **$ 240** | **$ (293)** | **$ (53)** |

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

*(2)* 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%.

The table above reflects the current low interest rate environment has impacted assets more than liabilities as indicated by the decrease of $293,000 in net interest income due to the rate change for the third quarter of 2012. This is not typical for the Company, as we have historically been liability sensitive in recent years. However, purchases of investment securities in the past 12 months at market interest rates lower than our overall portfolio reflects a decrease of $147,000 due to the lower yield of the new securities. The decreased loan volume was offset by the increase in investment securities and combined with the overall change in mix of balances resulted in an increase of $240,000 to net interest income over the same period.

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| | For the Nine Months Ended September 30, 2012 vs 2011 Increase (Decrease) in interest income and expense due to changes in: | | |
|---|---|---|---|
| | Volume | Rate | Total |
| **Interest income:** | | | |
| Gross loans (1) (2) | $ (135) | $ (680) | $ (815) |
| Investment securities (2) | 921 | (543) | 378 |
| Federal funds sold | (15) | 0 | (15) |
| Interest-earning deposits | 12 | 2 | 14 |
| **Total interest income** | $ **783** | $ **(1,221)** | $ **(438)** |
| | | | |
| **Interest expense:** | | | |
| Interest-earning DDA | | | |
| Money market deposits | 23 | (216) | (193) |
| NOW deposits | 0 | (22) | (22) |
| Savings deposits | 21 | (28) | (7) |
| Time CD $100K or more | (29) | (32) | (61) |
| Other time deposits | (13) | (56) | (69) |
| Other borrowings | (51) | 0 | (51) |
| **Total interest expense** | $ **(49)** | $ **(354)** | $ **(403)** |
| | | | |
| **Change in net interest income** | $ **832** | $ **(867)** | $ **(35)** |

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

*(2)* 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%.

The table above reflects the current low interest rate environment has impacted assets slightly more than liabilities as indicated by the decrease of $867,000 in net interest income due to the rate change for the first nine months of 2012. This is not typical for the Company, as we have historically been liability sensitive in recent years. However, purchases of investment securities in the past 12 months at market interest rates lower than our overall portfolio reflects a decrease of $543,000 due to the lower yield of the new securities. The decreased loan volume was offset by the increase in investment securities and combined with the overall change in mix of balances resulted in an increase of $832,000 to net interest income over the same period.

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**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, 2012, non-interest income was $790,000 and $2,294,000, respectively, an increase of $27,000 or 3.5% and $179,000 or 8.5%, compared to the same periods in 2011.

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

| | For the Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | 2011 | $ change | % change |
| Service charges on deposits | $ 287,101 | $ 306,081 | $ (18,980) | (6.2)% |
| Earnings on cash surrender value of life insurance | 105,000 | 109,710 | (4,710) | (4.3)% |
| Mortgage commissions | 63,792 | 37,080 | 26,712 | 72.0% |
| Other income | 334,556 | 310,499 | 24,057 | 7.7% |
| Total non-interest income | $ 790,449 | $ 763,370 | $ 27,079 | 3.5% |

| | For the Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | 2011 | $ change | % change |
| Service charges on deposits | $ 868,677 | $ 846,217 | $ 22,460 | 2.7% |
| Earnings on cash surrender value of life insurance | 315,000 | 324,668 | (9,668) | (3.0)% |
| Mortgage commissions | 171,579 | 63,900 | 107,679 | 168.5% |
| Other income | 938,579 | 879,771 | 58,808 | 6.7% |
| Total non-interest income | $ 2,293,835 | $ 2,114,556 | $ 179,279 | 8.5% |

Service charges on deposits decreased by $19,000 for the third quarter and increased by $22,000 nine months ended September 30, 2012, respectively, compared to the same periods in 2011, as a result of an increase in the number of transaction deposit accounts. Mortgage commissions have increased by $27,000 and $108,000 for the three and nine month periods of 2012, respectively, as compared to the same periods of 2011 as a result of the escalated demand for home purchases and refinancing due in part to the current low interest rate environment.

Other income increased by $24,000 and $59,000 for the three and nine month periods ended September 30, 2012, respectively, as compared to the comparable periods of 2011. Investment service fee income increased by $14,000 in the third quarter but decreased by $2,000 year-to date compared to the prior year. Merchant credit card fee income increased by $5,000 and $12,000 for the three and nine months ended September 30, 2012, respectively, compared to the same periods in 2011. Gains on called securities increased by $8,000 and $4,000 for the three and nine month periods ended September 30, 2012, respectively, as compared to the same periods in 2011. Also contributing to the increase in other income was a $120,000 operating recovery from a prior year items processing loss, which was recorded in the first quarter of 2012.

**Non-Interest Expense**

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

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

| | For the Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | 2011 | $ change | % change |
| Salaries and employee benefits | $ 2,462,468 | $ 2,356,589 | $ 105,879 | 4.5% |
| Occupancy | 766,401 | 731,512 | 34,889 | 4.8% |
| Data processing fees | 282,347 | 253,438 | 28,909 | 11.4% |
| OREO expenses | 0 | 8,497 | (8,497) | (100.0)% |
| Regulatory assessments (FDIC & DFI) | 114,000 | 135,000 | (21,000) | (15.6)% |
| Other | 901,973 | 723,095 | 178,878 | 24.7% |
| Total non-interest income | $ 4,527,189 | $ 4,208,131 | $ 319,058 | 7.6% |

| | For the Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | 2011 | $ change | % change |
| Salaries and employee benefits | $ 7,552,214 | $ 7,069,980 | $ 482,234 | 6.8% |
| Occupancy | 2,260,483 | 2,063,759 | 196,724 | 9.5% |
| Data processing fees | 838,211 | 751,965 | 86,246 | 11.5% |
| OREO expenses | 18,358 | 358,776 | (340,418) | (94.9)% |
| Regulatory assessments (FDIC & DFI) | 347,000 | 531,000 | (184,000) | (34.7)% |
| Other | 2,719,706 | 2,359,473 | 360,233 | 15.3% |
| Total non-interest income | $ 13,735,972 | $ 13,134,953 | $ 601,019 | 4.6% |

Non-interest expenses increased by $319,000 or 7.6% and $601,000 or 4.6% for the three and nine months ended September 30, 2012, respectively, as compared to the same periods of 2011. Salaries and employee benefits increased $106,000 and $482,000 for the three and nine months ended September 30, 2012, respectively, as compared to the same periods of 2011, primarily as a result of hiring new employees for new branch openings and additional bonus accruals corresponding to the Company s performance metrics. The new branch openings also contributed to the increase in occupancy expenses of $35,000 and $197,000, for the three and nine months ended September 30, 2012, respectively, as compared to the prior year. Data processing fees increased by $29,000 and $86,000 for the three and nine month periods ended September 30, 2012, respectively, as a result of an increased number of transaction accounts.

Other operating expenses increased by $179,000 and $360,000 for the three and nine months ended September 30, 2012, respectively, as compared to the same periods of 2011. These increases were due to a combination of expenses incurred to support the growth of our product lines and services, and a $75,000 insurance retention accrual recorded in the first quarter of 2012.

OREO expenses were $18,000 in the nine months ended September 30, 2012, compared to $359,000 for the comparable period of 2011. Included within these totals are OREO write downs, of which there were none for the three and nine month periods ended September 30, 2012, as compared to zero and $291,000, respectively, for the same periods of 2011. The remaining expense included in OREO expenses is attributed to general overhead such as property taxes and utilities associated with the properties classified as other real estate owned. There has been one sale of an OREO property which has reduced our OREO inventory from two properties as of September 30, 2011 to one property as of September 30, 2012. This OREO property sale was recorded in the first quarter of 2012 and resulted in a gain on sale of $4,000.

FDIC and DFI (California Department of Financial Institutions) regulatory assessments were $114,000 and $347,000 for the three and nine months ended September 30, 2012, respectively, representing decreases of $21,000 and $184,000 compared to the same periods of 2011. The

initial base assessment rate for financial institutions varies based on the overall risk profile of the institution as defined by the FDIC. The decrease in the third quarter and nine month period of 2012 is due to a lower base assessment rate as the Company has improved its overall risk ratings. The decrease in expense was in spite of a higher deposit base in 2012 as compared to 2011, as the FDIC assessment rates are applied to average quarterly total liabilities as the primary basis.

Management anticipates that noninterest expense will continue to increase as we continue to grow. 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 $738,000 and $2,096,000 for the three and nine month periods ended September 30, 2012, respectively, representing decreases of $107,000 and $165,000 as compared to the provisions reported in the comparable periods of 2011. The effective income tax rate on income from continuing operations was 33.3% and 32.8% for the three and nine months ended September 30, 2012, respectively, compared to 32.6% and 34.1% for the comparable periods of 2011. These provisions reflect accruals

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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 slight disparity between the effective tax rates year-to-date for 2012 as compared to 2011 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 2012 as compared to 2011.

**Asset Quality**

Nonperforming 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 $6.61 million at September 30, 2012, as compared to $7.23 million at December 31, 2011. The non-accrual loans as of September 30, 2012 are loans made to ten borrowers primarily for purposes of real estate construction and commercial real estate. As of September 30, 2012, we had six loans considered troubled debt restructurings totaling $2.63 million, all of which are included in nonaccrual loans.

OREO as of September 30, 2012 consisted of residential land acquired through foreclosure that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time.

The following table presents information about the Bank s non-performing loans, including asset quality ratios as of September 30, 2012 and December 31, 2011:

***Non-Performing Assets***

| (in thousands) | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Loans in non-accrual status | $ 6,611 | $ 7,233 |
| Loans past due 90 days or more and accruing | 0 | 0 |
| Total non-performing loans | 6,611 | 7,233 |
| Other real estate owned | 0 | 244 |

| | | | | |
|---|---|---|---|---|
| Total non-performing assets | $ | 6,611 | $ | 7,477 |
| | | | | |
| Allowance for loan losses | $ | 7,953 | $ | 8,609 |
| | | | | |
| Asset quality ratios: | | | | |
| Non-performing assets to total assets | | 1.05% | | 1.22% |
| Non-performing loans to total loans | | 1.70% | | 1.83% |
| Allowance for loan losses to total loans | | 2.05% | | 2.17% |
| Allowance for loan losses to total non-performing loans | | 120.3% | | 119.03% |

Non-performing assets decreased by $866,000 as of September 30, 2012 as compared to December 31, 2011, primarily as a result of the $622,000 reduction in non-accrual loans. This reduction was due to principal payments of $1,551,000 and charge-offs of $1,476,000, which was offset by additions of $1,916,000 for new loans placed on non-accrual status and an advance on an existing non-accrual loan of $489,000. Additionally, OREO balances decreased by $244,000 during the nine month period ended September 30, 2012 due to a sale of an OREO property.

***Allowance for Loan and Lease Losses ( ALLL )***

In anticipation of 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

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liabilities. The Company recorded loan loss provisions of $300,000 and $900,000 for the three and nine month periods in 2012, respectively, which was flat for the quarter and decreased by $300,000 year-to-date as compared to the provisions recorded in the same periods of 2011.

The allowance for loan losses decreased by $656,000 or 7.6%, to $7.95 million at September 30, 2012, as compared with $8.61 million at December 31, 2011. The Company recognized the decrease in the allowance for loan losses during the first nine months of the year due to the net loan charge-offs of $1,556,000 which was partially offset by loan loss provision of $900,000. The financial condition of certain Bank clients has stabilized which has improved the overall credit risk of the loan portfolio as evidenced by our decrease in non-accrual loans. The decrease to the allowance for loan losses resulted in a decrease in the allowance for loan losses as a percentage of total loans to 2.05% at September 30, 2012, as compared to 2.17% at December 31, 2011.

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 nonperforming 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, 2012 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 and Interest-bearing Deposits in other Financial Institutions*

The Company holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of September 30, 2012, and

December 31, 2011, we had $107.4 million and $101.1 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.

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**Deposits**

Total deposits at September 30, 2012 were $553.3 million, a $17.1 million or 3.2% increase from the deposit total of $536.2 million at December 31, 2011. Average deposits increased $36.3 million to $524.9 million for the nine month period ended September 30, 2012 as compared to the same period in 2011. We attracted deposits due to the safety and soundness of the Bank and our focus on customer service.

| (in thousands) | September 30, 2012 | December 31, 2011 | Nine month change $ | % |
|---|---|---|---|---|
| Demand | $ 147,935 | $ 130,143 | $ 17,792 | 13.7% |
| NOW | 73,219 | 72,867 | 352 | 0.5% |
| MMDA | 248,026 | 254,011 | (5,985) | (2.4)% |
| Savings | 25,920 | 18,915 | 7,005 | 37.0% |
| Time < $100K | 20,481 | 22,824 | (2,343) | (10.3)% |
| Time > $100K | 37,752 | 37,444 | 308 | 0.8% |
| | **$ 553,333** | **$ 536,204** | **$ 17,129** | **3.2%** |

Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. Eight of our clients carry deposit balances of more than 1% of our total deposits, one of which had a deposit balance of more than 3% of total deposits at September 30, 2012.

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 $2.0 million and $3.8 million in brokered deposits as of September 30, 2012 and December 31, 2011, 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 were paid in full during the first quarter of 2012 and remained a zero balance at September 30, 2012, as compared to $3.0 million at December 31, 2011 due to elevated liquidity levels from increased deposits and loan payments that allowed us to pay the advances off. See Liquidity Management below for the details on the FHLB borrowings program.

**Capital Ratios**

We are regulated by the Board of Governors of the Federal Reserve Board (FRB) and are subject to the securities registration and public reporting regulations of the Securities and Exchange Commission. Our banking subsidiary is regulated by the Federal Deposit Insurance

Corporation (FDIC) and the California Department of Financial Institutions (DFI). 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.

We must comply with regulatory capital requirements established by the FRB and FDIC. 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 4.00% 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 3.00% to 5.00%, depending upon the institution s composite ratings as determined by its regulators. The FRB has not advised us of any requirement specifically applicable to us.

Failure to meet minimum capital requirements can trigger regulatory actions that could have a material adverse effect on our financial

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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, 2012 and December 31, 2011:

***Oak Valley Community Bank Capital Ratios***

***(dollars in thousands)***

| | Actual | | Amount of Capital Required To Be Well-Capitalized | | To Be Adequately Capitalized | |
|---|---|---|---|---|---|---|
| | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| **As of September 30, 2012:** | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 70,793 | 15.7% | $ 44,974 | 10% | $ 35,979 | 8% |
| Tier 1 Capital (to Risk-Weighted Assets) | $ 65,131 | 14.5% | $ 26,984 | 6% | $ 17,989 | 4% |
| Tier 1 Capital (to Average Assets) | $ 65,131 | 10.8% | $ 30,300 | 5% | $ 24,240 | 4% |
| | | | | | | |
| **As of December 31, 2011:** | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 73,562 | 16.2% | $ 45,481 | 10% | $ 36,384 | 8% |
| Tier 1 Capital (to Risk-Weighted Assets) | $ 67,835 | 14.9% | $ 27,288 | 6% | $ 18,192 | 4% |
| Tier 1 Capital (to Average Assets) | $ 67,835 | 11.4% | $ 29,759 | 5% | $ 23,807 | 4% |

***Oak Valley Bancorp Capital Ratios***

***(dollars in thousands)***

| | Actual | | Amount of Capital Required To Be Well-Capitalized | | To Be Adequately Capitalized | |
|---|---|---|---|---|---|---|
| | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| **As of September 30, 2012:** | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 70,933 | 15.8% | N/A | N/A | $ 35,983 | 8% |
| Tier 1 Capital (to Risk-Weighted Assets) | $ 65,271 | 14.5% | N/A | N/A | $ 17,992 | 4% |
| Tier 1 Capital (to Average Assets) | $ 65,271 | 10.8% | N/A | N/A | $ 24,243 | 4% |
| | | | | | | |
| **As of December 31, 2011:** | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 73,439 | 16.2% | N/A | N/A | $ 36,387 | 8% |
| Tier 1 Capital (to Risk-Weighted Assets) | $ 67,712 | 14.9% | N/A | N/A | $ 18,193 | 4% |
| Tier 1 Capital (to Average Assets) | $ 67,712 | 11.4% | N/A | N/A | $ 23,809 | 4% |

Our bank subsidiary is also subject to capital requirements similar to those discussed above. The bank subsidiary s capital ratios do not vary materially from our capital ratios presented above. At September 30, 2012, our bank subsidiary exceeded the minimum ratios established by the FRB and FDIC.

**Liquidity Management**

Since the Company is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to the Company is restricted to the lesser of the Bank s retained earnings or the amount of the Bank s undistributed net profits from the previous three fiscal years. The primary uses of funds for the Company are stockholder dividends, investment in the Bank and ordinary operating expenses. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to the Company to meet its funding requirements for the foreseeable future.

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

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additional cost. For this purpose, we maintain a portion of our funds in cash and cash equivalents, salable government guaranteed loans and securities available for sale. We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and paydowns, Federal funds purchased, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificate of deposits, repayment of borrowings and dividends to common and preferred stockholders. Our liquid assets at September 30, 2012 were $178.1 million compared to $153.4 million at December 31, 2011. Our liquidity level measured as the percentage of liquid assets to total assets was 28.4% and 25.1% at September 30, 2012 and December 31, 2011, respectively. We anticipate that cash and cash equivalents on hand and other sources of funds will provide adequate liquidity for our operating, investing and financing needs and our regulatory liquidity requirements for the foreseeable future. Management monitors our liquidity position daily, balancing loan funding/payments with changes in deposit activity and overnight investments.

As a secondary source of liquidity, we rely on advances from the FHLB to supplement our supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are typically secured by a portion of our loan portfolio. The FHLB determines limitations on the amount of advances by assigning a percentage to each eligible loan category that will count towards the borrowing capacity. As of September 30, 2012, our borrowing capacity from the FHLB was approximately $137.0 million and there were no outstanding advances. We also maintain 2 lines of credit with correspondent banks to purchase up to $25 million in federal funds, for which there were no advances as of September 30, 2012.

**Off-Balance-Sheet Arrangements**

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

As of September 30, 2012 and December 31, 2011, we had commitments to extend credit of $40.1 million and $46.4 million, respectively, which includes obligations under letters of credit of $0.9 million and $0.6 million, respectively.

The effect on our revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

**Item 4. Controls and Procedures**

The Company s Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company s disclosure controls and procedures, as defined in Exchange Act Rules 13 a-15(e) and 15(d)-15(e) promulgated under the Exchange Act, as of the end of the period covered by this report (the Evaluation Date ) have concluded that as of the Evaluation Date, the Company s disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would be made known to them by others within the Company, particularly during the period in which this report was being prepared. Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no significant changes in our internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting subsequent to the Evaluation Date, nor were there any significant deficiencies or material weaknesses in such controls requiring corrective actions.

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## PART II - OTHER INFORMATION

**Item 1. Legal Proceedings**

There are no pending, or to management s knowledge, any threatened, material legal proceedings to which we are a defendant, or to which any of our properties are subject. There are no material legal proceedings to which any director, any nominee for election as a director, any executive officer, or any associate of any such director, nominee or officer is a party adverse to us.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

The following exhibits are filed as part of this report or hereby incorporated by reference to filings previously made with the SEC:

| **Exhibit No.** | **Exhibit Description** |
|---|---|
| 3.1 | Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form 10-12B filed with the Securities and Exchange Commission on July 31, 2008). |
| 3.2 | First Amendment to Articles of Incorporation (incorporated by reference to Exhibit 3.2 to the Company s Registration Statement on Form 10-12B filed with the Securities and Exchange Commission on July 31, 2008). |
| 3.3 | Bylaws (incorporated by reference to Exhibit 3.3 to the Company s Registration Statement on Form 10-12B filed with the Securities and Exchange Commission on July 31, 2008). |
| 3.4 | Certificate of Amendment of Bylaws (incorporated by reference to Exhibit 3.5 to the Company s Registration Statement on Form 8-A12B filed with the Securities and Exchange Commission on January 14, 2009). |
| 3.5 | Certificate of Amendment of Bylaws dated effective as of August 11, 2011. * |
| 4.1 | Certificate of Determination dated December 2, 2008 filed with the California Secretary of State for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference to Exhibit 3.4 to the Company s Registration Statement on Form 8-A12B filed with the Securities and Exchange Commission on January 14, 2009). |
| 4.2 | Warrant to Purchase Common Stock dated December 5, 2008 (incorporated by reference to Exhibit 10.4 to the Company s Registration Statement on Form 8-A12B filed with the Securities and Exchange Commission on January 14, 2009). |
| 4.3 | Certificate of Determination dated August 11, 2011 and filed with the California Secretary of State for Senior Non-Cumulative Perpetual Preferred Stock, Series B. * |
| 10.1 | Securities Purchase Agreement dated August 11, 2011 between the Company and the Secretary of the U.S. Treasury, with respect to the issuance and sale of Senior Non-Cumulative Perpetual Preferred Stock, Series B.* |
| 10.2 | Warrant Redemption Letter Agreement dated September 28, 2011 between the Company and the U.S. Treasury, with respect to the redemption of the Warrant to Purchase Common Stock dated December 5, 2008.* |
| 31.01 | Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.02 | Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.01 | Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema Document |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF** | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document |

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* Incorporated by reference to the Company s Form 10-Q for the quarter ending September 30, 2011, filed on November 14, 2011.

**In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

| | **Oak Valley Bancorp** | |
|---|---|---|
| Date: November 13, 2012 | By: | /s/ RICHARD A. MCCARTY |
| | | **Richard A. McCarty** |
| | | **Executive Vice President and Chief Financial Officer** |
| | | **(Principal Financial Officer and duly authorized signatory)** |

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