SIERRA BANCORP
Form 10-Q
November 08, 2012

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012

Commission file number: 000-33063

**Sierra Bancorp**

(Exact name of Registrant as specified in its charter)

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

| | |
|---|---|
| 86 North Main Street, Porterville, California | 93257 |
| (Address of principal executive offices) | (Zip Code) |

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

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

Yes R No £

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

Yes R No £

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes £ No R

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

Common stock, no par value, 14,106,889 shares outstanding as of October 31, 2012

**FORM 10-Q**

**Table of Contents**

**PART I - FINANCIAL INFORMATION**

**Item 1 – Financial Statements**

**SIERRA BANCORP**

**CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

| | September 30, 2012 (unaudited) | December 31, 2011 (audited) |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ 41,744 | $ 42,805 |
| Interest-bearing deposits in banks | 3,351 | 20,231 |
| Total Cash & Cash Equivalents | 45,095 | 63,036 |
| Investment securities available for sale | 414,635 | 406,471 |
| Loans held for sale | 618 | 1,354 |
| Loans and leases: | | |
| Gross loans and leases | 847,130 | 757,591 |
| Allowance for loan and lease losses | (12,806) | (17,283) |
| Deferred loan and lease fees, net | 926 | 621 |
| Net Loans and Leases | 835,250 | 740,929 |
| Premises and equipment, net | 22,218 | 20,721 |
| Operating leases, net | 268 | 384 |
| Foreclosed assets | 19,835 | 15,364 |
| Goodwill | 5,544 | 5,544 |
| Other assets | 79,839 | 81,602 |
| TOTAL ASSETS | $ 1,423,302 | $ 1,335,405 |
| | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing | $ 323,184 | $ 300,045 |
| Interest bearing | 822,669 | 786,223 |
| Total Deposits | 1,145,853 | 1,086,268 |
| Federal funds purchased and repurchase agreements | 3,634 | 3,037 |
| Short-term borrowings | 47,900 | 17,120 |
| Long-term borrowings | 5,000 | 15,000 |
| Junior subordinated debentures | 30,928 | 30,928 |
| Other liabilities | 15,514 | 14,488 |
| TOTAL LIABILITIES | 1,248,829 | 1,166,841 |
| SHAREHOLDERS' EQUITY | | |
| Common stock, no par value; 24,000,000 shares | | |

| | | |
|---|---|---|
| authorized; 14,103,849 and 14,101,609 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 64,344 | 64,321 |
| Additional paid in capital | 2,364 | 2,221 |
| Retained earnings | 101,877 | 98,174 |
| Accumulated other comprehensive income | 5,888 | 3,848 |
| TOTAL SHAREHOLDERS' EQUITY | 174,473 | 168,564 |
| | | |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ 1,423,302 | $ 1,335,405 |

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

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**SIERRA BANCORP**

**CONSOLIDATED STATEMENTS OF INCOME**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income: | | | | |
| Interest and fees on loans | $ 11,954 | $ 11,780 | $ 34,251 | $ 35,480 |
| Interest on investment securities: | | | | |
| Taxable | 1,523 | 2,420 | 5,159 | 6,621 |
| Tax-exempt | 700 | 716 | 2,052 | 2,153 |
| Interest on federal funds sold and interest-bearing deposits | 15 | 23 | 51 | 56 |
| Total interest income | 14,192 | 14,939 | 41,513 | 44,310 |
| | | | | |
| Interest expense: | | | | |
| Interest on deposits | 796 | 1,063 | 2,490 | 3,279 |
| Interest on short-term borrowings | 23 | 7 | 41 | 46 |
| Interest on long-term borrowings | 51 | 143 | 231 | 425 |
| Interest on mandatorily redeemable trust preferred securities | 193 | 179 | 586 | 540 |
| Total interest expense | 1,063 | 1,392 | 3,348 | 4,290 |
| | | | | |
| Net Interest Income | 13,129 | 13,547 | 38,165 | 40,020 |
| | | | | |
| Provision for loan losses | 4,700 | 3,000 | 10,610 | 9,600 |
| | | | | |
| Net Interest Income after Provision for Loan Losses | 8,429 | 10,547 | 27,555 | 30,420 |
| | | | | |
| Non-interest revenue: | | | | |
| Service charges on deposit accounts | 2,525 | 2,439 | 7,229 | 7,140 |
| Gains on investment securities available-for-sale | 90 | - | 161 | - |
| Other income, net | 1,281 | 930 | 4,831 | 3,278 |
| Total other operating income | 3,896 | 3,369 | 12,221 | 10,418 |
| | | | | |
| Other operating expense: | | | | |
| Salaries and employee benefits | 5,278 | 4,849 | 15,855 | 15,760 |
| Occupancy expense | 1,669 | 1,787 | 4,721 | 4,987 |
| Other | 4,064 | 3,932 | 13,059 | 13,078 |
| Total other operating expenses | 11,011 | 10,568 | 33,635 | 33,825 |

| | | | | |
|---|---|---|---|---|
| Income before income taxes | 1,314 | 3,348 | 6,141 | 7,013 |
| Provision for income taxes | (321) | 822 | 54 | 774 |
| Net Income | $ 1,635 | $ 2,526 | $ 6,087 | $ 6,239 |
| PER SHARE DATA | | | | |
| Book value | $ 12.37 | $ 11.97 | $ 12.37 | $ 11.97 |
| Cash dividends | $ 0.06 | $ 0.06 | $ 0.18 | $ 0.18 |
| Earnings per share basic | $ 0.12 | $ 0.18 | $ 0.43 | $ 0.45 |
| Earnings per share diluted | $ 0.12 | $ 0.18 | $ 0.43 | $ 0.44 |
| Average shares outstanding, basic | 14,103,543 | 14,051,614 | 14,102,880 | 14,015,583 |
| Average shares outstanding, diluted | 14,138,682 | 14,097,368 | 14,114,962 | 14,081,936 |
| Total shareholder Equity (in thousands) | $ 174,473 | $ 168,325 | $ 174,473 | $ 168,325 |
| Shares outstanding | 14,103,849 | 14,062,259 | 14,103,849 | 14,062,259 |
| Dividends Paid | $ 846,193 | $ 842,800 | $ 2,538,482 | $ 2,521,643 |

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

**SIERRA BANCORP**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in thousands, unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net Income | $ 1,635 | $ 2,526 | $ 6,087 | $ 6,239 |
| Other comprehensive income, before tax: | | | | |
| Unrealized gains on securities: | | | | |
| Unrealized holding gains arising during period | 1,926 | 1,838 | 3,635 | 7,127 |
| Less: reclassification adjustment for gains included in net income | (90) | - | (161) | - |
| Other comprehensive income, before tax | 1,836 | 1,838 | 3,474 | 7,127 |
| Income tax expense related to items of other comprehensive income, net of tax | (756) | 765 | (1,434) | 2,928 |
| Other comprehensive income | 1,080 | 1,073 | 2,040 | 4,199 |
| Comprehensive income | $ 2,715 | $ 3,599 | $ 8,127 | $ 10,438 |

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

**SIERRA BANCORP**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in thousands, unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | $ 6,087 | $ 6,239 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Gain on investment of securities | (161) | - |
| Gain on sales of loans | (139) | (93) |
| Loss (Gain) on disposal of fixed assets | 10 | (12) |
| Loss on sale on foreclosed assets | 709 | 569 |
| Writedowns on foreclosed assets | 1,610 | 1,656 |
| Share-based compensation expense | 183 | 166 |
| Provision for loan losses | 10,610 | 9,600 |
| Depreciation and amortization | 1,813 | 1,971 |
| Net amortization on securities premiums and discounts | 6,214 | 4,031 |
| Increase in unearned net loan fees | (304) | (291) |
| Increase in cash surrender value of life insurance policies | (30) | (5,538) |
| Proceeds from sales of loans portfolio | 5,717 | 3,440 |
| Net (Increase) Decrease in loans held-for-sale | (4,842) | 59 |
| (Increase) Decrease in interest receivable and other assets | (677) | 1,362 |
| Increase (Decrease) in other liabilities | 1,179 | (389) |
| Net Decrease in FHLB Stock | 670 | 996 |
| Deferred Income Tax Provision (Benefit) | 318 | (105) |
| Excess tax (provision) benefit from equity based compensation | (39) | 4 |
| Net cash provided by operating activities | 28,928 | 23,665 |
| | | |
| Cash flows from investing activities: | | |
| Maturities of securities available for sale | 1,080 | 2,664 |
| Proceeds from sales/calls of securities available for sale | 11,319 | 3,119 |
| Purchases of securities available for sale | (99,084) | (154,229) |
| Principal pay downs on securities available for sale | 75,953 | 53,430 |
| Net (Increase) Decrease in loans receivable, net | (125,316) | 28,709 |
| Purchases of premises and equipment, net | (3,204) | (830) |
| Proceeds from sales of foreclosed assets | 13,898 | 4,681 |
| Net cash used in investing activities | (125,354) | (62,456) |
| | | |
| Cash flows from financing activities: | | |
| Increase in deposits | 59,585 | 41,345 |
| Increase in borrowed funds | 20,780 | 10,350 |
| Increase in repurchase agreements | 597 | 4,633 |
| Cash dividends paid | (2,538) | (2,522) |

| | | |
|---|---|---|
| Repurchases of common stock | - | (23) |
| Stock options exercised | 22 | 672 |
| Excess tax provision (benefit) from equity based compensation | 39 | (4) |
| Net cash provided by financing activities | 78,485 | 54,451 |
| | | |
| (Decrease) Increase in cash and due from banks | (17,941) | 15,660 |
| | | |
| Cash and Cash Equivalents | | |
| Beginning of period | 63,036 | 42,645 |
| End of period | $ 45,095 | $ 58,305 |

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

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Sierra Bancorp

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

September 30, 2012

***Note 1 – The Business of Sierra Bancorp***

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company's only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities (TRUPS). Pursuant to the Financial Accounting Standards Board's (FASB's) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. Our branch footprint stretches from Fresno on the north to Bakersfield on the south, and on the southern end extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. We currently operate 25 full service branch offices throughout our geographic footprint, as well as an internet branch which provides the ability to open deposit accounts online. The Bank's most recent branch expansion activity includes a new branch which opened for business in the city of Selma in February 2011, and the relocation of our Clovis branch to a larger facility in a more convenient location in the third quarter of 2012. In addition to our full-service branches, the Bank has an agricultural credit division with lending staff domiciled in Porterville, Bakersfield and Visalia, an SBA lending unit located at our corporate headquarters, and offsite ATM's at six different non-branch locations. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

***Note 2 – Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles

(GAAP) for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. In preparing the accompanying consolidated financial statements, management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2011 have been reclassified to be consistent with the reporting for 2012. The interim financial information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission.

**Note 3 – Current Accounting Developments**

In September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2011-08, *Intangibles—Goodwill and Other (Topic 350) - Testing Goodwill for Impairment*. The objective of ASU 2011-08 is to simplify how entities test goodwill for impairment. Topic 350 requires an entity to test goodwill for impairment on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Pursuant to ASU 2011-08, an entity will not be required to calculate the fair value of a reporting unit and perform step one unless, after assessing qualitative factors, the entity determines that it is more likely than not that its fair value is less than its carrying amount. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of ASU 2011-08 did not have an impact on the Company’s financial statements, as the Company has not been required to perform the second step of the goodwill impairment test since the first step has, to date, determined that the fair value of the reporting unit, Bank of the Sierra, is greater than its carrying amount.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220) - Presentation of Comprehensive Income*. Current U.S. generally accepted accounting principles allow reporting entities several alternatives for displaying other comprehensive income and its components in financial statements, and ASU 2011-05 is intended to improve the consistency of this reporting issue. The amendments in this ASU require all non-owner changes in stockholders’ equity to be presented either in a single continuous statement of comprehensive income, or in two separate but consecutive statements. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in the statement of net income. The statement of other comprehensive income should immediately follow the statement of net income and include the components of other comprehensive income and a total for other comprehensive income, along with a total for comprehensive income. Furthermore, the entity is required to present, on the face of the financial statements, adjustments for items that are reclassified from other comprehensive income to net income in the statements, where the components of net income and the components of other comprehensive income are presented. The amendments in the ASU do not change the following: 1) items that must be reported in other comprehensive income; 2) when an item of other comprehensive income must be reclassified to net income; 3) the option to present components of other comprehensive income either net of related tax effects or before related tax effects; or, 4) how earnings per share is calculated or presented. The amendments in ASU 2011-05 should be applied retrospectively. For public entities, such as the Company, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company’s adoption of this ASU impacted our presentation of comprehensive income, but not the calculation of such.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, to substantially converge the fair value measurement and disclosure guidance in U.S. GAAP with International Financial Reporting Standards (“IFRS”). The amended guidance changes several aspects of current fair value measurement guidance, including the following provisions: 1) the application of the concepts of “highest and best use” and “valuation premise”; 2) the introduction of an option to measure groups of offsetting assets and liabilities on a net basis; 3) the incorporation of certain premiums and discounts in fair value measurements; and, 4) the measurement of the fair value of certain instruments classified in shareholders’ equity. In addition, the amended guidance includes several new fair value disclosure requirements, including, among other things, information about valuation techniques and unobservable inputs used in Level 3 fair value measurements and a narrative description of Level 3 measurements’ sensitivity to changes in unobservable inputs. For public entities such as the Company, the provisions of ASU 2011-04 are effective for interim and annual periods beginning after December 15, 2011, and are to be applied prospectively. The implementation of ASU 2011-04 enhanced our footnote disclosures, but did not change fair value measurements for any of the Company’s assets or liabilities carried at fair value and thus did not impact the Company’s statements of income and condition.

***<u>Note 4 – Supplemental Disclosure of Cash Flow Information</u>***

During the nine months ended September 30, 2012 and 2011, cash paid for interest due on interest-bearing liabilities was $3.087 million and $3.991 million, respectively. There was no cash paid for income taxes during the nine months ended September 30, 2012, and $1.643 million for the same time frame in 2011. Assets totaling $20.724 million and $4.663 million were acquired in settlement of loans for the nine months ended September 30, 2012 and September 30, 2011, respectively. We received $10.134 million in cash from the sale of foreclosed assets during the first nine months of 2012 relative to $2.779 million during the first nine months of 2011, which represents sales proceeds less loans extended to finance such sales totaling $3.735 million for the first nine months of 2012 and $1.506 million for the first nine months of 2011.

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***Note 5 – Share Based Compensation***

The 2007 Stock Incentive Plan (the "2007 Plan") was adopted by the Company in 2007. Our 1998 Stock Option Plan (the "1998 Plan") was concurrently terminated, although options to purchase 171,550 shares that were granted prior to the termination of the 1998 Plan were still outstanding as of September 30, 2012 and remain unaffected by the termination. The 2007 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors of the Company. The 2007 Plan also provides for the potential issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although options have been granted since the inception of the plan and the number remaining available for grant as of September 30, 2012 was 911,640. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share. No restricted stock awards have been issued by the Company.

Pursuant to FASB's standards on stock compensation, the value of each option granted is reflected in our income statement as share-based compensation expense or directors' expense, by amortizing it over the vesting period of such option or by expensing it as of the grant date for immediately vested options. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee's options for each vesting period are separately valued and amortized. This appears to be the preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of $61,000 was reflected in the Company's income statement during the third quarter of 2012 and $48,000 was charged during the third quarter of 2011, as expense related to stock options. For the first nine months, the charges amounted to $183,000 in 2012 and $166,000 in 2011.

***Note 6 – Earnings per Share***

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 14,103,543 weighted average shares outstanding during the third quarter of 2012, and 14,051,614 during the third quarter of 2011. There were 14,102,880 weighted average shares outstanding during the first nine months of 2012, and 14,015,583 during the first nine months of 2011.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of "in-the-money" stock options. The dilutive effect of options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the third quarter and first nine months of 2012, the dilutive effect of options outstanding calculated under the treasury stock method totaled 35,139 and 12,082, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the third quarter and first nine months of 2011 shares totaling 45,754 and 66,353, respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

*Note 7 – Comprehensive Income*

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

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

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

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commitments to extend credit | $ 239,849 | $ 154,323 |
| Standby letters of credit | $ 6,059 | $ 11,113 |
| Commercial letters of credit | $ 8,543 | $ 8,991 |

Commitments to extend credit consist primarily of the following: Unfunded home equity lines of credit; commercial real estate construction loans, which are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction; commercial revolving lines of credit, which have a high degree of industry diversification; the unused portions of mortgage warehouse lines of credit; and the unused portions of formalized (disclosed) deposit account overdraft lines. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company's commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

The Company is also utilizing a $74 million letter of credit issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits. The letter of credit is backed by specific loans which are pledged to the Federal Home Loan Bank by the Company.

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

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

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

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

- Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized gains and losses could have a significant effect on fair value estimates but have not been considered in any estimates. Because no market exists for a significant portion of the Company's financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments disclosed at September 30, 2012 and December 31, 2011:

- Cash and cash equivalents and short-term borrowings: For cash and cash equivalents and short-term borrowings, the carrying amount is estimated to be fair value.

- Investment securities: The fair values of investment securities are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.

- Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms, to borrowers of comparable creditworthiness. The carrying amount of accrued interest receivable approximates its fair value.

- Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available-for-sale loans stay on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

- Collateral dependent impaired loans: Impaired loans carried at fair value are those for which it is probable that the bank will be unable to collect all amounts due (including both interest and principal) according to the contractual terms of the original loan agreement, and the carrying value has been written down to the fair value of the loan. The carrying value is equivalent to the fair value of the collateral, net of expected disposition costs where applicable, for collateral-dependent loans.

- Cash surrender value of life insurance policies: The fair values are based on net cash surrender values at each reporting date.

- Investments in, and capital commitments to, limited partnerships: The fair values of our investments in WNC Institutional Tax Credit Fund Limited Partnerships and any other limited partnerships are estimated using quarterly indications of value provided by the general partner. The fair values of undisbursed capital commitments are assumed to be the same as their book values.

- Other investments: Certain long-term investments for which no secondary market exists are carried at cost, and the carrying amount for those investments approximates their estimated fair value.

- Deposits: Fair values for demand deposits and other non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

- Short-term borrowings: The carrying amounts approximate fair values for federal funds purchased, overnight FHLB advances, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

- Long-term borrowings: The fair values of the Company’s long-term borrowings are estimated using projected cash flows discounted at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

- Subordinated debentures: The fair values of subordinated debentures are determined based on the current market value for like instruments of a similar maturity and structure.

- Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would approximate fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

Estimated fair values for the Company’s financial instruments at the periods noted are as follows:

**Fair Value of Financial Instruments**

| (dollars in thousands, unaudited) | September 30, 2012 | | | | |
|---|---|---|---|---|---|
| | | Estimated Fair Value | | | |
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| | | (Dollars in thousands) | | | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | $45,095 | $45,095 | $ - | $ - | $45,095 |
| Investment securities available for sale | 414,635 | 1,911 | 412,724 | - | 414,635 |
| Loans and leases, net | 823,850 | - | 867,484 | - | 867,484 |
| Collateral dependent impaired loans | 11,401 | - | 9,044 | - | 9,044 |
| Loans held-for-sale | 618 | 618 | - | - | 618 |
| Cash surrender value of life insurance policies | 37,687 | - | 37,687 | - | 37,687 |
| Other investments | 6,370 | - | 6,370 | - | 6,370 |
| Investment in Limited Partnership | 10,537 | - | 10,537 | - | 10,537 |
| Accrued interest receivable | 5,228 | - | 5,228 | - | 5,228 |
| Financial Liabilities: | | | | | |
| Deposits: | | | | | |
| Noninterest-bearing | $323,184 | $323,184 | $ - | $ - | $323,184 |
| Interest-bearing | 822,669 | - | 745,132 | - | 745,132 |
| Fed Funds Purchased and Repurchase Agreements | 3,634 | - | 3,634 | - | 3,634 |
| Short-term borrowings | 47,900 | - | 47,900 | - | 47,900 |
| Long-term borrowings | 5,000 | - | 5,084 | - | 5,084 |
| Subordinated debentures | 30,928 | - | 12,141 | - | 12,141 |
| Limited partnership capital commitment | 1,138 | - | 1,138 | - | 1,138 |
| Accrued Interest Payable | 252 | - | 252 | - | 252 |

| | Notional Amount |
|---|---|
| Off-balance-sheet financial instruments: | |
| Commitments to extend credit | $239,849 |
| Standby letters of credit | 6,059 |
| Commercial lines of credit | 8,543 |

| | December 31, 2011 | |
|---|---|---|
| | | Estimated Fair Value |

| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|---|---|---|---|---|
| | | (Dollars in thousands) | | | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | $63,036 | $63,036 | $ - | $ - | $63,036 |
| Investment securities available for sale | 406,471 | 1,347 | 405,124 | - | 406,471 |
| Loans and leases, net | 726,302 | - | 771,192 | - | 771,192 |
| Collateral dependent impaired loans | 14,627 | - | 11,016 | 285 | 11,301 |
| Loans held-for-sale | 1,354 | 1,354 | - | - | 1,354 |
| Cash surrender value of life insurance policies | 37,657 | - | 37,657 | - | 37,657 |
| Other Investments | 7,040 | - | 7,040 | - | 7,040 |
| Investment in Limited Partnership | 9,927 | - | 9,927 | - | 9,927 |
| Accrued Interest Receivable | 5,368 | - | 5,368 | - | 5,368 |
| Financial Liabilities: | | | | | |
| Deposits: | | | | | |
| Noninterest-bearing | $300,045 | $300,045 | $ - | $ - | $300,045 |
| Interest-bearing | 786,223 | - | 702,270 | - | 702,270 |
| Fed Funds Purchased and Repurchase Agreements | 3,037 | - | 3,037 | - | 3,037 |
| Short-term borrowings | 17,120 | - | 17,120 | - | 17,120 |
| Long-term borrowings | 15,000 | - | 15,000 | - | 15,000 |
| Subordinated debentures | 30,928 | - | 12,262 | - | 12,262 |
| Limited partnership capital commitment | 353 | - | 353 | - | 353 |
| Accrued Interest Payable | 514 | - | 514 | - | 514 |

| | Notional Amount |
|---|---|
| Off-balance-sheet financial instruments: | |
| Commitments to extend credit | $154,323 |
| Standby letters of credit | 11,113 |
| Commercial lines of credit | 8,991 |

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For each financial asset category that was actually reported at fair value at September 30, 2012 and December 31, 2011, the Company used the following methods and significant assumptions:

- Investment Securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on the their relationship to other benchmark quoted securities.

- Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available-for-sale loans stay on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

- Impaired loans: Impaired loans carried at fair value are those for which it is probable that the bank will be unable to collect all amounts due (including both interest and principal) according to the contractual terms of the original loan agreement, and the carrying value has been written down to the fair value of the loan. The carrying value is equivalent to the fair value of the collateral, net of expected disposition costs where applicable, for collateral-dependent loans.

- Foreclosed assets: Repossessed real estate (OREO) and other assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes, and for all other assets fair value is represented by the estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

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

Fair Value Measurements - Recurring
(dollars in thousands, unaudited)

| | Fair Value Measurements at September 30, 2012, Using | | | | |
|---|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total | Realized Gain/(Loss) |
| Investment Securities | | | | | |
| U.S. Government agencies | $ - | $ 1,134 | $ - | $ 1,134 | $ - |
| Obligations of states and political subdivisions | - | 80,963 | - | 80,963 | - |
| U.S. Government agencies collateralized by mortgage obligations | - | 330,627 | - | 330,627 | - |
| Other Securities | 1,911 | - | - | 1,911 | - |
| Total available-for-sale securities | $ 1,911 | $ 412,724 | $ - | $ 414,635 | $ - |

| | Fair Value Measurements at December 31, 2011, Using | | | | |
|---|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total | Realized Gain/(Loss) |
| Investment Securities | | | | | |
| U.S. Government agencies | $ - | $ 2,026 | $ - | $ 2,026 | $ - |
| Obligations of states and political subdivisions | - | 71,340 | - | 71,340 | - |
| U.S. Government agencies collateralized by mortgage obligations | - | 331,758 | - | 331,758 | - |
| Other Securities | 1,347 | - | - | 1,347 | (1,370) |
| Total available-for-sale securities | $ 1,347 | $ 405,124 | $ - | $ 406,471 | $ (1,370) |

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

Fair Value Measurements - Nonrecurring
(dollars in thousands, unaudited)

| | Fair Value Measurements at September 30, 2012, Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Collateral Dependent Impaired Loans | $- | $ 9,044 | $ - | $9,044 |
| Foreclosed Assets | $- | $ 19,835 | $ - | $19,835 |

| | Fair Value Measurements at December 31, 2011, Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Collateral Dependent Impaired Loans | $- | $ 11,016 | $ 285 | $11,301 |
| Foreclosed Assets | $- | $ 14,777 | $ 587 | $15,364 |

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

The unobservable inputs are based on management's best estimates of appropriate discounts in arriving at fair market value. Significant increases or decreases in any of those inputs could result in a significantly lower or higher fair value measurement. For example, a change in either direction of actual loss rates would have a directionally opposite change in the calculation of the fair value of impaired unsecured loans.

***<u>Note 10 – Investments</u>***

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB's guidance on accounting for debt and equity securities, available for sale securities are carried on the Company's financial statements at their estimated fair market values, with monthly tax-effected "mark-to-market" adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity. The Company's available-for-sale investment securities totaled $415 million at September 30, 2012, and $406 million at December 31, 2011.

**Amortized Cost And Estimated Fair Value**

The amortized cost and estimated fair value of investment securities available-for-sale are as follows

(Dollars in thousands, unaudited):

| | September 30, 2012 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Government agencies | $1,129 | $ 5 | $ - | $1,134 |
| Obligations of state and political subdivisions | 76,558 | 4,480 | (75 ) | 80,963 |
| U.S. Government agencies collateralized by mortgage obligations | 325,605 | 5,763 | (741 ) | 330,627 |
| Equity Securities | 1,336 | 575 | - | 1,911 |
| | $404,628 | $ 10,823 | $ (816 ) | $414,635 |

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Government agencies | $2,008 | $ 18 | $ - | $2,026 |
| Obligations of state and political subdivisions | 67,851 | 3,634 | (145 ) | 71,340 |
| U.S. Government agencies collateralized by mortgage obligations | 328,751 | 4,467 | (1,460 ) | 331,758 |
| Equity Securities | 1,336 | 11 | - | 1,347 |
| | $399,946 | $ 8,130 | $ (1,605 ) | $406,471 |

At September 30, 2012 and December 31, 2011, the Company had 76 securities and 80 securities, respectively, with unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the associated unrealized losses are other than temporary. Information pertaining to our investment securities with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous loss position, is disclosed in the table below.

Investment Portfolio - Unrealized Losses

| (dollars in thousands, unaudited) | September 30, 2012 | |
|---|---|---|
| | Less than Twelve Months | Over Twelve Months |
| | Gross Unrealized Losses | |