SIERRA BANCORP
Form 10-Q
August 09, 2011

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 JUNE 30, 2011

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, 14,046,666 shares outstanding as of August 1, 2011

FORM 10-Q

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PART I - FINANCIAL INFORMATION
Item 1

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	June 30, 2011 (unaudited)	December 31, 2010 (audited)
ASSETS		
Cash and due from banks	$ 49,265	$ 42,110
Interest-bearing deposits in banks	19,102	325
Federal Funds Sold	-	210
Total Cash & Cash Equivalents	68,367	42,645
Investment securities available for sale	402,736	331,730
Loans and leases:		
Loans held for sale	-	914
Gross loans and leases	772,551	804,626
Allowance for loan and lease losses	(20,711)	(21,138)
Deferred loan and lease fees, net	229	113
Net Loans and Leases	752,069	784,515
Premises and equipment, net	20,033	20,190
Operating leases, net	547	904
Foreclosed assets	18,231	20,691
Goodwill	5,544	5,544
Other assets	78,372	80,352
TOTAL ASSETS	$ 1,345,899	$ 1,286,571
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Non-interest bearing	$ 273,684	$ 251,908
Interest bearing	842,482	800,366
Total Deposits	1,116,166	1,052,274
Federal funds purchased and repurchase agreements	3,980	-
Short-term borrowings	-	14,650
Long-term borrowings	15,000	15,000
Other liabilities	14,413	14,122
Junior subordinated debentures	30,928	30,928
TOTAL LIABILITIES	1,180,487	1,126,974
SHAREHOLDERS' EQUITY		
Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued	-	-
Common stock, no par value; 24,000,000 shares authorized; 14,046,666 and 13,976,741 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively	64,024	63,477
Additional paid in capital	1,760	1,652
Retained earnings	95,604	93,570
Accumulated other comprehensive income	4,024	898
TOTAL SHAREHOLDERS' EQUITY	165,412	159,597

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$	1,345,899	$	1,286,571

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)

	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2011	2011	2011	2011
Interest income:				
Interest and fees on loans	$ 11,918	$ 13,495	$ 23,700	$ 27,073
Interest on investment securities:				
Taxable	2,285	2,043	4,201	4,150
Tax-exempt	721	673	1,437	1,318
Interest on Federal funds sold and interest-bearing deposits	25	5	33	22
Total interest income	14,949	16,216	29,371	32,563
Interest expense:				
Interest on deposits	1,125	1,671	2,216	3,329
Interest on short-term borrowings	5	55	39	92
Interest on long-term borrowings	142	142	282	318
Interest on manditorily redeemable trust preferred securities	180	180	361	355
Total interest expense	1,452	2,048	2,898	4,094
Net Interest Income	13,497	14,168	26,473	28,469
Provision for loan losses	3,000	3,500	6,600	6,900
Net Interest Income after Provision for Loan Losses	10,497	10,668	19,873	21,569
Non-interest revenue:				
Service charges on deposit accounts	2,446	2,887	4,701	5,590
Other income, net	1,027	1,102	2,348	2,260
Total other operating income	3,473	3,989	7,049	7,850
Other operating expense:				
Salaries and employee benefits	5,201	5,151	10,911	10,930
Occupancy expense	1,625	1,819	3,200	3,559
Other	4,729	4,578	9,146	9,232
Total other operating expenses	11,555	11,548	23,257	23,721
Income before income taxes	2,415	3,109	3,665	5,698
Provision for income taxes	231	565	(48)	814
Net Income	$ 2,184	$ 2,544	$ 3,713	$ 4,884
PER SHARE DATA				

Book value	$ 11.78	$ 12.00	$ 11.78	$ 12.00
Cash dividends	$ 0.06	$ 0.06	$ 0.12	$ 0.12
Earnings per share basic	$ 0.16	$ 0.22	$ 0.27	$ 0.42
Earnings per share diluted	$ 0.16	$ 0.22	$ 0.26	$ 0.42
Average shares outstanding, basic	14,012,574	11,646,409	13,997,264	11,638,638
Average shares outstanding, diluted	14,084,997	11,749,546	14,072,974	11,723,566

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

SIERRA BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands, unaudited)

	Six Months Ended June 30, 2011	2010
Cash flows from operating activities:		
Net income	$ 3,713	$ 4,884
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of loans	(53)	(37)
(Gain) loss on disposal of fixed assets	(12)	115
Loss on sale on foreclosed assets	296	337
Writedowns on foreclosed assets	1,305	653
Share-based compensation expense	117	68
Provision for loan losses	6,600	6,900
Depreciation and amortization	1,257	1,535
Net amortization on securities premiums and discounts	2,660	1,372
Increase in unearned net loan fees	(117)	(330)
Increase in cash surrender value of life insurance policies	(707)	(506)
Proceeds from sales of loans	1,725	932
Net decrease (increase) in loans held-for-sale	914	(498)
Decrease (increase) in interest receivable and other assets	1,766	(2,004)
Decrease in other liabilities	(1,361)	(572)
Net decrease in restricted stock, at cost	670	334
Deferred income tax (benefit) provision	(6)	13
Excess tax provision (benefit) from equity based compensation	10	(12)
Net cash provided by operating activities	18,777	13,184
Cash flows from investing activities:		
Maturities of securities available for sale	408	4,960
Proceeds from sales/calls of securities available for sale	1,275	6,912
Purchases of securities available for sale	(104,699)	(73,005)
Principal paydowns on securities available for sale	34,638	33,589
Decrease in loans receivable, net	20,543	7,564
Purchases of premises and equipment, net	(734)	(1,185)
Proceeds from sales of foreclosed assets	3,434	2,911
Net cash used in investing activities	(45,135)	(18,254)
Cash flows from financing activities:		
Increase (decrease) in deposits	63,892	(33,830)
Decrease (increase) in borrowed funds	(14,650)	21,900
Increase in fed funds purchased	3,980	-
Cash dividends paid	(1,679)	(1,397)
Payments of stock issuance costs	(23)	-
Stock options exercised	570	225
Excess tax (benefit) provision from equity based compensation	(10)	12
Net cash provided by (used in) financing activities	52,080	(13,090)

Increase (decrease) in cash and due from banks		25,722		(18,160)
Cash and Cash Equivalents				
Beginning of period		42,645		66,235
End of period	$	68,367	$	48,075

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

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SIERRA BANCORP
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2011

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the "Company"), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the "Bank") in August 2001. The Company's principal subsidiary is the Bank, and 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. 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 and submit certain loan applications online. The Bank's newest "brick and mortar" branches opened for business in Selma in February 2011 and Farmersville in March 2010. In January 2011 we closed our first branch ever, in Bakersfield on California Avenue due to lease issues, and we are currently searching for a suitable location to replace that branch. In addition to our full-service branches, the Bank has an agricultural credit division and an SBA lending unit with staff located at our corporate headquarters, and offsite ATM's at eight 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 2010 have been reclassified to be consistent with the reporting for 2011. 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, 2010, as filed with the Securities and Exchange Commission.

Note 3 – Current Accounting Developments

In June 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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. Early adoption is permitted. The Company's adoption of this ASU will impact 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 is not expected to change fair value measurements for any of the Company's assets or liabilities carried at fair value, and thus should not impact the Company's statements of income and condition.

In April 2011, the FASB issued ASU No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring, in an effort to improve financial reporting by creating greater consistency in the way GAAP is applied for various types of debt restructurings. ASU 2011-02 is intended to assist creditors in determining whether a modification of the terms of a loan meets the criteria to be considered a troubled debt restructuring ("TDR"), both for purposes of recording an impairment loss and for disclosure of TDR's. In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that both of the following exist: 1) the restructuring constitutes a concession; and 2) the debtor is experiencing financial difficulties. The amendments to Topic 310 clarify the guidance on a creditor's evaluation of whether it has granted a concession, and likewise clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulties. In addition, the amendments to Topic 310 preclude creditors from using the effective interest rate test in the debtor's guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a TDR. For public companies, such as Sierra Bancorp, the new guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. Early adoption is permitted, and the Company has adopted the provisions of ASU 2011-02 for the reporting period ended June 30, 2011. There was a total of $552,000 in loan balances that were added to performing TDR's at June 30, 2011 as a direct result of the Company's adoption of ASU 2011-02, with only a negligible impact on our allowance for loan and lease losses.

In July 2010, the FASB updated disclosure requirements with respect to the credit quality of financing receivables and the allowance for credit losses. According to the guidance, there are two levels of detail at which credit information must be presented - the portfolio segment level and class level. The portfolio segment level is defined as the level where financing receivables are aggregated in developing a company's systematic method for calculating its allowance for credit losses. The class level is the second level at which credit information will be presented, and represents the categorization of financing receivables at a slightly less aggregated level than the portfolio segment level. Companies are required to provide the following disclosures as a result of this update: A roll-forward of the allowance for credit losses at the portfolio segment level, with the ending balances further categorized according to impairment method along with the balance reported in the related financing receivables at period-end; additional disclosures of nonaccrual and impaired financing receivables by class as of period-end; credit quality and past due/aging information by class as of period-end; information surrounding the nature and extent of loan modifications and troubled-debt restructurings and their effect on the allowance for credit losses during the period; and details on any significant purchases or sales of financing receivables during the period. The increased period-end disclosure requirements became effective for periods ending on or after December 15, 2010, with the exception of the additional period-end disclosures surrounding troubled-debt restructurings which were deferred in December 2010 and became effective for annual and interim reporting periods ending on or after June 15, 2011. The increased disclosures for activity within a reporting period become effective for periods beginning on or after June 15, 2011, with retrospective application to January 1, 2011. The provisions of this FASB update expanded the Company's current disclosures with respect to our allowance for loan and lease losses and the credit quality of our financing receivables.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This update added disclosure requirements for significant transfers into and out of Levels 1 and 2, clarified existing fair value disclosure requirements about the appropriate level of disaggregation, and clarified that a description of the valuation techniques was required for recurring and nonrecurring Level 2 and 3 fair value measurements. The Company adopted these provisions of the ASU in preparing the Consolidated Financial Statements commencing with the period ended March 31, 2010. The adoption of these provisions only affected the disclosure requirements for fair value measurements and as a result had no impact on the Company's statements of income and condition. An additional requirement of this ASU is that activity within Level 3, including purchases, sales, issuances, and settlements, be presented on a gross basis rather than as a net number as currently permitted. This provision of the ASU became effective for the Company's reporting period ending March 31, 2011. As this provision only amended the disclosure requirements for fair value measurements, our adoption of it had no impact on the Company's statements of income and condition.

Note 4 – Supplemental Disclosure of Cash Flow Information

During the six months ended June 30, 2011 and 2010, cash paid for interest due on interest-bearing liabilities was $2.942 million and $4.304 million, respectively. There was $1.643 million in cash paid for income taxes during the six months ended June 30, 2011, and $5.360 million in cash paid for income taxes during the six months ended June 30, 2010. Assets totaling $2.948 million and $5.455 million were acquired in settlement of loans for the six months ended June 30, 2011 and June 30, 2010, respectively, and we received $3.268 million in cash from the sale of foreclosed assets during the first half of 2011 relative to $2.911 million during the first half of 2010. The Company extended $1.381 million in loans to finance the sale of foreclosed assets during the six months ended June 30, 2011, but none during the first six months of 2010.

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 292,723 shares that were granted prior to the termination of the 1998 Plan were still outstanding as of June 30, 2011 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 and available 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 June 30, 2011 was 1,040,360. No restricted stock awards have been issued by the Company.

Pursuant to FASB's standards on stock compensation, share-based compensation expense is reflected in our income statement for each option granted over the vesting period of such option. 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 $53,000 was reflected in the Company's income statement during the second quarter of 2011 and $28,000 was charged during the second quarter of 2010, as compensation expense related to outstanding and unvested stock options. For the first half, these charges amounted to $118,000 in 2011 and $66,000 in 2010.

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 14,012,574 weighted average shares outstanding during the second quarter of 2011, and 11,646,409 during the second quarter of 2010. There were 13,997,264 weighted average shares outstanding during the first six months of 2011, and 11,638,638 during the first six months of 2010.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to "in-the-money" shares that would be issued on the exercise of outstanding 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 second quarter and first six months of 2011, the dilutive effect of options outstanding calculated under the treasury stock method totaled 72,423 and 75,710, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the second quarter and first six months of 2010, shares totaling 103,137 and 84,928, respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 – Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company's only source of other comprehensive income is derived from unrealized gains and losses on available-for-sale investment securities. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company's comprehensive income was as follows:

Comprehensive Income

(dollars in thousands, unaudited)	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2011	2010	2011	2010
Net Income	$ 2,184	$ 2,544	$ 3,713	$ 4,884
Other comprehensive income:				
Unrealized holding gain	3,450	1,366	5,289	2,550
Less: reclassification adjustment	-	-	-	-
Pre-tax other comprehensive inc/(loss)	3,450	1,366	5,289	2,550
Less: tax impact of above	1,450	574	2,223	1,072
Net other comprehensive income	2,000	792	3,066	1,478
Comprehensive income	$ 4,184	$ 3,336	$ 6,779	$ 6,362

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. These 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 making loans included on the balance sheet. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	June 30, 2011	December 31, 2010
Commitments to extend credit	$ 143,501	$ 142,309
Standby letters of credit	$ 11,380	$ 7,761
Commercial letters of credit	$ 9,427	$ 9,435

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Commitments to extend credit consist primarily of unfunded single-family residential construction loans and home equity lines of credit, and commercial real estate construction loans and commercial revolving lines of credit. Construction loans 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 have a high degree of industry diversification. 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.

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 all 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. These 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 the realization of unrealized gains and losses can have a significant effect on fair value estimates and 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. These estimates are subjective in nature 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 June 30, 2011 and December 31, 2010:

- 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 the securities' relationship to other benchmark quoted securities when quoted prices for the 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. Fair values of loans held for sale are estimated using quoted market prices for similar loans or the amount that has been committed to purchase the loan. The carrying amount of accrued interest receivable approximates its fair value.

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

- Investment 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: Included in other assets are certain long-term investments carried at cost, which 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: Commitments to extend credit are primarily for adjustable rate loans. Commitments to fund fixed rate loans and letters of credit, where such exist, are also at rates which approximate market rates at each reporting date. Thus, if funded, the carrying amounts 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 these 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 June 30, 2011 and December 31, 2010 are as follows:

Fair Value of Financial Instruments (dollars in thousands, unaudited)	June 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	68,367	68,367	42,645	42,645
Investment securities available for sale	402,736	402,736	331,730	331,730
Loans and leases, net	752,069	780,684	784,515	816,185
Cash surrender value of life insurance policies	32,298	32,298	31,591	31,591
Other investments	7,691	7,691	8,361	8,361
Investments in limited partnerships	10,198	10,198	10,899	10,899
Accrued interest receivable	5,695	5,695	5,677	5,677
Financial liabilities:				
Deposits	1,116,166	1,117,063	1,052,274	1,052,085
Repurchase agreements	3,980	3,980	-	-
Overnight borrowings	-	-	9,650	9,650
Short-term borrowings	-	-	5,000	5,000
Long-term borrowings	15,000	15,529	15,000	15,736
Subordinated debentures	30,928	11,651	30,928	11,610
Limited partnership capital commitment	392	764	417	417
Accrued interest payable	722	722	678	678

	Notional Amount	Notional Amount
Off-balance-sheet financial instruments:		
Commitments to extend credit	143,501	142,309
Standby letters of credit	11,380	7,761
Commercial letters of credit	9,427	9,435

For each category of financial assets that were actually reported at fair value at June 30, 2011, the Company used the following methods and significant assumptions:

- Investment Securities: The fair values of trading securities and 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 original contractual terms of the loan agreement, and for which 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, for collateral-dependent loans, or the present value of anticipated future cash flows for other loans.

- Foreclosed assets: Repossessed real estate (OREO) and other assets are carried at the lower of cost or fair value. Fair value is appraised value less expected selling costs for OREO and some other assets such as mobile homes, and estimated sales proceeds as determined by using reasonably available sources for all other assets. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Other foreclosed assets are periodically re-evaluated by adjusting expected cash flows and timing of resolution, again using reasonably available sources. 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 June 30, 2011, Using			
	Level 1	Level 2	Level 3	Total
Investment Securities				
U.S. Government agencies	$ -	$ 5,028	$ -	$ 5,028
Obligations of states and political subdivisions	-	73,922	-	73,922
U.S. Government agencies collateralized by mortgage obligations	-	322,171	-	322,171
Other Securities	1,615	-	-	1,615
Total availabe-for-sale securities	1,615	401,121	-	402,736
Loans Held for Sale	-	-	-	-
Total	$ 1,615	$ 401,121	$ -	$ 402,736

	Fair Value Measurements at December 31, 2010, Using			
	Level 1	Level 2	Level 3	Total
Investment Securities				
U.S. Government agencies	$ -	$ 5,062	$ -	$ 5,062
Obligations of states and political subdivisions	-	70,102	-	70,102
U.S. Government agencies collateralized by mortgage obligations	-	255,143	-	255,143
Other Securities	1,423	-	-	1,423
Total availabe-for-sale securities	1,423	330,307	-	331,730
Loans Held for Sale	914	-	-	914
Total	$ 2,337	$ 330,307	$ -	$ 332,644

Assets for which a nonrecurring change in fair value has been recorded are summarized below:

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

	Fair Value Measurements at June 30, 2011, Using			
	Level 1	Level 2	Level 3	Total
Impaired Loans	$ -	$ 26,312	$ 13,699	$ 40,011
Foreclosed Assets	$ -	$ 16,273	$ 1,958	$ 18,231

Fair Value Measurements at December 31, 2010, Using

	Level 1	Level 2	Level 3	Total
Impaired Loans	$ -	$ 29,482	$ 6,705	$ 36,187
Foreclosed Assets	$ -	$ 3,123	$ 17,568	$ 20,691

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 Management's Discussion and Analysis of Financial Condition and Results of Operation, in the "Credit Quality and Nonperforming Assets" and "Allowance for Loan and Lease Losses" sections.

PART I - FINANCIAL INFORMATION

ITEM 2

MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as "expects", "anticipates", "believes", "projects", and "estimates" or variations of such words and similar expressions are intende to identify forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company's financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include, but are not limited to, continued deterioration in economic conditions in the Company's service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the Company's ability to secure buyers for foreclosed properties; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; the Company's ability to attract and retain skilled employees; the Company's ability to successfully deploy new technology; the success of branch expansion; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

CRITICAL ACCOUNTING POLICIES

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan and lease losses, as explained in detail in the "Provision for Loan and Lease Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, which is discussed under "Credit Quality and Nonperforming Assets" and "Allowance for Loan and Lease Losses"; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on the fair value of the Company and for which it has been determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.

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OVERVIEW OF THE RESULTS OF OPERATIONS AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

Second Quarter 2011 compared to Second Quarter 2010

Net income for the quarter ended June 30, 2011 was $2.184 million, representing a decline of $360,000, or 14%, relative to net income of $2.544 million for the quarter ended June 30, 2010. Basic and diluted earnings per share for the second quarter of 2011 were $0.16, compared to $0.22 basic and diluted earnings per share for the second quarter of 2010. The Company's annualized return on average equity was 5.36% and annualized return on average assets was 0.65% for the quarter ended June 30, 2011, compared to a return on equity of 7.36% and return on assets of 0.77% for the quarter ended June 30, 2010. The primary drivers behind the variance in net income are as follows:

- Net interest income was down $671,000, or 5%, due to a 27 basis point drop in the Company's net interest margin, partially offset by a $15 million increase in average interest-earning assets. Negative factors impacting our net interest margin in the second quarter of 2011 include lower loan yields resulting from increased competition for quality loans, and a shift from average loan balances into lower-yielding investment balances. These negatives were partially offset by net interest recoveries in the second quarter of 2011, a reduced reliance on interest-bearing liabilities due to growth in average non-interest bearing deposits and equity, and a shift in average balances from non-deposit borrowings and CDARS deposits into lower-cost core deposit categories.

- The Company's loan loss provision was reduced by $500,000, or 14%. Thus far in 2011, our loan loss provision has been utilized to provide specific reserves for impaired loans and to replenish reserves subsequent to loan charge-offs. Net loans charged off totaled $3.753 million in the second quarter of 2011, including a $1.4 million charge-off associated with a single non-accruing loan for which we had a $1.2 million reserve already established as of year-end 2010. Net charge-offs were $2.722 million in the second quarter of 2010.

- Total non-interest revenue declined by $516,000, or 13%, due primarily to a drop in overdraft income resulting from procedural changes implemented pursuant to regulatory guidance. Another unfavorable variance in non-interest income was the result of a $378,000 increase in costs associated with low-income housing tax credit investments, which are accounted for as a reduction in income. These unfavorable variances were partially offset by a higher level of debit card interchange income, higher merchant fees, an increase in income on bank-owned life insurance associated with deferred compensation plans, and gains on leased equipment subsequent to the termination of leases.

- Total operating expense had a negligible variance for the quarterly comparison. Salaries and benefits increased by only $50,000, or 1%, despite the addition of staff for newer branches and a $120,000 increase in deferred compensation accruals. Occupancy expense declined by $194,000, or 11%, for the quarter, due mainly to a drop in depreciation expense, lower maintenance/repair costs, and the January 2011 closure of a branch with a relatively costly lease. Other non-interest expenses increased by an aggregate $151,000, or 3%, due in large part to a $501,000 increase in write-downs on foreclosed assets and an increase in directors deferred fee accruals, which were partially offset by favorable variances in certain other costs including those associated with online deposit accounts and internet banking, marketing expense, FDIC assessments, and sundry losses.

First Half 2011 Compared to First Half 2010

Net income for the first six months of 2011 was $3.713 million, a drop of $1.171 million, or 24%, relative to net income for the first six months of 2010. Basic and diluted earnings per share were $0.27 and $0.26, respectively, for the first six months of 2011, compared to $0.42 basic and diluted earnings per share for the first six months of 2010. The Company realized an annualized return on average equity of 4.62% for the first half of 2011 and 7.17% for the first half of 2010, and a return on assets for the same periods of 0.57% and 0.74%, respectively. The principal reasons for the first half net income variance include the following:

- Net interest income declined by $1.996 million, due to a 29 basis point net interest margin decline and a $9 million drop in average interest-earning assets. The drop in our net interest margin for the comparative year-to-date periods was the result of the same circumstances discussed for the quarterly comparison.

- The Company's provision for loan losses was $6.6 million in the first half of 2011, which represents a drop of $300,000, or 4%, relative to the first half of 2010. Net charge-offs increased by $1.3 million, however, due to the charge-off of a pre-established reserve on a non-performing loan that was resolved in the second quarter of 2011.

- Total non-interest income declined by $801,000, or 10%. Similar to the quarterly comparison, the largest changes in the components of non-interest income for the half include lower overdraft fee income and higher low-income housing tax credit investment costs, partially offset by an increase in income generated by deferred compensation BOLI, a higher level of debit card interchange fees, and gains realized upon the termination of equipment leases.

- Total non-interest expense reflects a drop of $464,000, or 2%, for the first half of 2011. Significant reductions within this category are evident in occupancy expense, marketing costs, internet banking and online account costs, foreclosed asset operating expense, FDIC assessments, and sundry losses. These reductions were partially offset by a $692,000 increase in write-downs on foreclosed assets, and higher directors deferred fee costs.

- The Company recorded a negative income tax provision of $48,000 for the first half of 2011, as compared to a provision of $814,000 for the first half of 2011 that resulted in a tax accrual rate of 14%. The income tax provision was negative for the first half of 2011 due to a high level of tax credits relative to taxable income, as adjusted for the favorable impact of tax-exempt interest income and BOLI income.

FINANCIAL CONDITION SUMMARY

June 30, 2011 relative to December 31, 2010

The most significant characteristics of, and changes in, the Company's balance sheet during the first six months of 2011 are outlined below:

- The Company's assets totaled $1.346 billion at June 30, 2011, an increase of $59 million, or 5%, relative to total assets of $1.287 billion at December 31, 2010. Total assets increased due to growth in investment securities and an increase in cash and balances due from banks, partially offset by lower loan balances. Gross loan and lease balances declined $33 million, or 4%, due to runoff in the normal course of business, prepayments, transfers to OREO, and charge-offs. Weak loan demand from quality borrowers and aggressive competition have hindered our ability to counteract this contraction.

- The $65 million balance of nonperforming assets at June 30, 2011 reflects a decline of $1 million, or 2%, since year-end 2010, and is well below its peak of $78 million reached a year earlier. In addition to nonperforming assets we had $14.3 million in performing restructured troubled debt (TDR's) at June 30, 2011, an increase of $2 million, or 15%, relative to year-end 2010.

- Our allowance for loan and lease losses was $20.7 million as of June 30, 2011, which represents a slight decline relative to the balance at year-end 2010 due primarily to the charge-off of a pre-established specific reserve that was included in the allowance at December 31, 2010. Even though the allowance for loan and lease losses fell slightly, our allowance as a percentage of total loans increased by 6 basis points, to 2.68% at June 30, 2011 from 2.62% at December 31, 2010, because loan balances fell during the first half of the year.

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Total deposits increased by $64 million, or 6%. While $33 million of that growth was in core non-maturity deposits, NOW deposits dropped by $6 million, or 3%, due to runoff in our online-only accounts subsequent to interest rate adjustments. We also added $15 million in longer-term wholesale-sourced brokered deposits for interest rate risk management purposes, in order to create a more defensive posture for the eventuality of rising interest rates. Federal Home Loan Bank borrowings were reduced by $15 million during the first six months of the year, but other borrowings increased by $4 million subsequent to a customer's transfer of $4 million from money market deposits into a non-deposit sweep account.

- Total capital increased by $6 million, or 4%, to $165 million at June 30, 2011. Because capital increased and risk-adjusted assets declined, our consolidated total risk-based capital ratio increased to 21.38% at June 30, 2011 from 20.33% at year-end 2010. Further, our tier one risk-based capital ratio was 20.12% and our tier one leverage ratio was 13.75% at June 30, 2011.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which consists mainly of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

NET INTEREST INCOME AND NET INTEREST MARGIN

For the second quarter of 2011 relative to the second quarter of 2010, net interest income declined by $671,000, or 5%. For the year-to-date comparison, net interest income declined by $1.996 million, or 7%. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volume of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

The following Average Balances and Rates tables show the average balance of each significant balance sheet category, and the amount of interest income or interest expense associated with that category, for the comparative quarters and year-to-date periods. The tables also show the calculated yields on each major component of the Company's investment and loan portfolio, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin for the periods noted.

Average Balances and Rates (dollars in thousands, except per share data)	For the Quarter Ended June 30, 2011 (1)(2)(3)			For the Quarter Ended June 30, 2010 (1)(2)(3)		
	Average Balance	Income/ Expense	Average Rate/Yield	Average Balance	Income/ Expense	Average Rate/Yield
Assets						
Investments:						
Federal funds sold/due from time	$ 36,802	$ 25	0.27 %	$ 10,215	$ 5	0.19 %
Taxable	312,808	2,285	2.89 %	234,371	2,043	3.45 %
Non-taxable	73,396	721	5.98 %	67,829	673	6.04 %
Equity	1,595	-	0.00 %	1,607	-	0.00 %
Total Investments	424,601	3,031	3.19 %	314,022	2,721	3.88 %
Loans and Leases:(4) (5)						
Agricultural	13,886	179	5.17 %	9,719	122	5.03 %
Commercial	107,006	1,598	5.99 %	119,237	1,784	6.00 %
Real Estate	556,509	9,091	6.55 %	623,481	10,285	6.62 %
Consumer	41,031	946	9.25 %	51,286	1,139	8.91 %
Direct Financing Leases	7,117	104	5.86 %	11,484	165	5.76 %
Other	48,459	-	0.00 %	54,702	-	0.00 %
Total Loans and Leases	774,008	11,918	6.18 %	869,909	13,495	6.22 %
Total Interest Earning Assets (5)	1,198,609	14,949	5.13 %	1,183,931	16,216	5.62 %
Other Earning Assets	7,882			9,196		
Non-Earning Assets	133,018			131,800		
Total Assets	$ 1,339,509			$ 1,324,927		
Liabilities and Shareholders' Equity						
Interest Bearing Deposits:						
NOW	$ 175,621	$ 205	0.47 %	$ 182,036	$ 530	1.17 %
Savings Accounts	83,492	50	0.24 %	69,641	41	0.24 %
Money Market	165,083	192	0.46 %	167,208	245	0.59 %
CDAR's	49,144	71	0.59 %	78,669	168	0.86 %
Certificates of Deposit<$100,000	158,083	271	0.69 %	144,702	296	0.82 %
Certificates of Deposit≥$100,000	196,870	286	0.58 %	193,209	315	0.65 %
Brokered Deposits	15,000	50	1.34 %	15,000	76	2.03 %
Total Interest Bearing Deposits	843,293	1,125	0.54 %	850,465	1,671	0.79 %
Borrowed Funds:						
Federal Funds Purchased	3	-	0.00 %	-	-	0.00 %
Repurchase Agreements	1,634	5	1.23 %	-	-	0.00 %

Short Term Borrowings	1	-	0.00 %	26,676	55	0.83 %
Long Term Borrowings	15,000	142	3.80 %	15,000	142	3.80 %
TRUPS	30,928	180	2.33 %	30,928	180	2.33 %
Total Borrowed Funds	47,566	327	2.76 %	72,604	377	2.08 %
Total Interest Bearing Liabilities	890,859	1,452	0.65 %	923,069	2,048	0.89 %
Demand Deposits	269,716			248,832		
Other Liabilities	15,559			14,454		
Shareholders' Equity	163,375			138,572		
Total Liabilities and Shareholders' Equity	$ 1,339,509			$ 1,324,927		
Interest Income/Interest Earning Assets			5.13 %			5.62 %
Interest Expense/Interest Earning Assets			0.48 %			0.70 %
Net Interest Income and Margin(6)		$ 13,497	4.65 %		$ 14,168	4.92 %

(1)Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2)Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

(3)Annualized

(4)Net loan costs have been included in the calculation of interest income. Net loan costs were approximately $145 thousand and $148 thousand for the quarters ended June 30, 2011 and 2010.

Loans are gross of the allowance for possible loan losses.

(5)Non-accrual loans have been included in total loans for purposes of total earning assets.

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

Average Balances and Rates (dollars in thousands, except per share data)	For the Six Months Ended June 30, 2011 (1)(2)(3)			For the Six Months Ended June 30, 2010 (1)(2)(3)		
	Average Balance	Income/ Expense	Average Rate/Yield	Average Balance	Income/ Expense	Average Rate/Yield
Assets						
Investments:						
Federal funds sold/due from time	$ 25,967	$ 33	0.25 %	$ 16,073	$ 22	0.27 %
Taxable	294,874	4,201	2.83 %	228,162	4,150	3.62 %
Non-taxable	72,609	1,437	6.06 %	66,064	1,318	6.10 %
Equity	1,572	-	0.00 %	1,563	-	0.00 %
Total Investments	395,022	5,671	3.24 %	311,862	5,490	3.95 %
Loans and Leases:(4)(5)						
Agricultural	12,992	331	5.14 %	9,696	242	5.03 %
Commercial	104,609	3,120	6.01 %	119,181	3,538	5.99 %
Real Estate	563,054	18,140	6.50 %	625,169	20,693	6.67 %
Consumer	42,548	1,890	8.96 %	52,990	2,263	8.61 %
Direct Financing Leases	7,530	219	5.86 %	11,832	337	5.74 %
Other	49,091	-	0.00 %	53,190	-	0.00 %
Total Loans and Leases	779,824	23,700	6.13 %	872,058	27,073	6.26 %
Total Interest Earning Assets (5)	1,174,846	29,371	5.17 %	1,183,920	32,563	5.67 %
Other Earning Assets	8,114			9,278		
Non-Earning Assets	133,510			129,758		
Total Assets	$ 1,316,470			$ 1,322,956		
Liabilities and Shareholders' Equity						
Interest Bearing Deposits:						
NOW	$ 176,358	$ 420	0.48 %	$ 171,352	$ 914	1.08 %
Savings Accounts	80,852	96	0.24 %	67,378	77	0.23 %
Money Market	160,811	382	0.48 %	171,248	497	0.59 %
CDAR's	40,998	125	0.61 %	96,359	431	0.90 %
Certificates of Deposit<$100,000	159,727	545	0.69 %	144,648	616	0.86 %
Certificates of Deposit≥$100,000	194,093	573	0.60 %	193,754	621	0.65 %
Brokered Deposits	10,939	75	1.38 %	18,083	173	1.93 %
Total Interest Bearing Deposits	823,778	2,216	0.54 %	862,822	3,329	0.78 %
Borrowed Funds:						
Federal Funds Purchased	3	-	0.00 %	2	-	0.00 %
Repurchase Agreements	821	4	0.98 %	-	-	0.00 %

Short Term Borrowings		2,538		35	2.78	%		18,084	92	1.03	%
Long Term Borrowings		15,000		282	3.79	%		17,099	318	3.75	%
TRUPS		30,928		361	2.35	%		30,928	355	2.31	%
Total Borrowed Funds		49,290		682	2.79	%		66,113	765	2.33	%
Total Interest Bearing Liabilities		873,068		2,898	0.67	%		928,935	4,094	0.89	%
Demand Deposits		265,781						243,251			
Other Liabilities		15,524						13,459			
Shareholders' Equity		162,097						137,311			
Total Liabilities and Shareholders' Equity	$	1,316,470					$	1,322,956			
Interest Income/Interest Earning Assets					5.17	%				5.67	%
Interest Expense/Interest Earning Assets					0.50	%				0.70	%
Net Interest Income and Margin(6)			$	26,473	4.68	%			$ 28,469	4.97	%

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(1)Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2)Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

(3)Annualized

(4)Net loan costs have been included in the calculation of interest income. Net loan costs were approximately $338 thousand and $187 thousand for the six months ended June 30, 2011 and 2010.

Loans are gross of the allowance for possible loan losses.

(5)Non-accrual loans have been included in total loans for purposes of total earning assets.

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

The Volume and Rate Variances table below sets forth the dollar difference in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in average balance multiplied by prior period rates, and rate variances are equal to the increase or decrease in rate times prior period average balances. Variances attributable to both rate and volume changes are calculated by multiplying the change in rate by the change in average balance, and have been allocated to the rate variance.

Volume & Rate Variances (dollars in thousands)	Quarter Ended June 30, 2011 over 2010 Increase(decrease) due to			Six Months Ended June 30, 2011 over 2010 Increase(decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
Assets:						
Investments:						
Federal funds sold / Due from time	$ 13	$ 7	$ 20	$ 14	$ (3)	$ 11
Taxable	684	(442)	242	1,213	(1,162)	51
Non-taxable(1)	55	(7)	48	131	(12)	119
Equity	-	-	-	-	-	-
Total Investments	752	(442)	310	1,358	(1,177)	181
Loans and Leases:						
Agricultural	52	5	57	82	7	89
Commercial	(183)	(3)	(186)	(433)	15	(418)
Real Estate	(1,105)	(89)	(1,194)	(2,056)	(497)	(2,553)
Consumer	(228)	35	(193)	(446)	73	(373)
Direct Financing Leases	(63)	2	(61)	(123)	5	(118)
Other	-	-	-	-	-	-
Total Loans and Leases	(1,527)	(50)	(1,577)	(2,976)	(397)	(3,373)
Total Interest Earning Assets	(775)	(492)	(1,267)	(1,618)	(1,574)	(3,192)
Liabilities						
Interest Bearing Deposits:						
NOW	(19)	(307)	(326)	27	(521)	(494)
Savings Accounts	8	1	9	15	4	19
Money Market	(3)	(51)	(54)	(30)	(85)	(115)
CDAR's	(63)	(33)	(96)	(248)	(58)	(306)
Certificates of Deposit < $100,000	27	(51)	(24)	64	(135)	(71)
Certificates of Deposit > $100,000	6	(35)	(29)	1	(49)	(48)
Brokered Deposits	-	(26)	(26)	(68)	(30)	(98)
Total Interest Bearing Deposits	(44)	(502)	(546)	(239)	(874)	(1,113)
Borrowed Funds:						
	-	-	-	-	-	-

Federal Funds Purchased						
Repurchase Agreements	-	5	5	-	4	4
Short Term Borrowings	(55)	-	(55)	(79)	22	(57)
Long Term Borrowings	-	-	-	(39)	3	(36)
TRUPS	-	-	-	-	6	6
Total Borrowed Funds	(55)	5	(50)	(118)	35	(83)
Total Interest Bearing Liabilities	(99)	(497)	(596)	(357)	(839)	(1,196)
Net Interest Margin/Income	$ (676)	$ 5	$ (671)	$ (1,261)	$ (735)	$ (1,996)

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

As shown above, the volume variance for the second quarter of 2011 relative to the second quarter of 2010 was negative $676,000, despite the fact that average interest-earning assets were $15 million higher. The negative volume variance was primarily the result of an unfavorable shift in average earning asset balances. We experienced a $96 million drop in average loans due to declining balances of relatively high-yielding real estate, commercial and consumer loans, and there was a corresponding increase of $111 million in the average balance of investments, including a $27 million increase in overnight fed funds sold and short-term interest-earning deposits in other banks, which have yields that are significantly lower than average loan yields. Unfavorable changes in average asset balances were partially countered by positive swings in average liability and equity balances. We experienced movement out of CDARS and wholesale borrowings into lower-cost core deposits for the comparative quarters, including a $21 million increase in the average balance of non-interest bearing demand deposits. A $25 million increase in average equity, resulting from our registered direct offering in October 2010 and the addition of net income, also helped reduced our reliance on interest-bearing liabilities and thus helped limit the magnitude of the negative volume variance.

The impact of interest rate changes on net interest income was effectively neutral for the quarterly comparison, with just a $5,000 favorable rate variance. There hasn't been a significant change in market interest rates during the past year, but our weighted average yield on interest-earning assets was 49 basis points lower due to the addition of investment securities in a relatively low-rate environment, and lower real estate loan yields, which declined 7 basis points due to increased competition for quality loans. Factors offsetting the negative pressures on our rate variance include a drop in our weighted average cost of interest-bearing liabilities, which was 24 basis points lower due primarily to a 70 basis point drop in the cost of NOW accounts and an improving deposit mix. Also helping offset the negative factors impacting the rate variance were net interest recoveries of $97,000 on resolved non-accrual loans in the second quarter of 2011 relative to net interest reversals of $120,000 on loans placed on non-accrual status in the second quarter of 2010, and a $32 million reduction in average interest-bearing liabilities facilitated by increases in average demand deposits and average equity.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.65% in the second quarter of 2011, a decline of 27 basis points relative to the second quarter of 2010. Negative factors impacting our net interest margin in 2011 include a shift from average loan balances into lower-yielding investment balances and lower real estate loan yields. Having a favorable impact on our net interest margin were a shift in average balances from higher-cost liabilities into lower-cost core deposits, a reduced reliance on interest-bearing liabilities, and net interest recoveries. We expect that our net interest margin could continue to experience slight contraction due to heightened competitive pressures on loan yields, and that effect will be exacerbated if the negative trend in loan balances is not reversed.

For the first half of 2011 relative to the first half of 2010, the negative variance in net interest income attributable purely to volume changes was $1.261 million, and there was a negative rate variance of $735,000. The negative volume variance for the half was due in part to the fact that average interest-earning assets declined by $9 million. Furthermore, as with the quarterly comparison, there was movement out of average loan balances into lower-yielding investments, although that unfavorable shift was partially offset by relatively strong growth in the average balance of low-cost customer deposits and equity.

The same factors discussed for the quarterly rate variance were applicable with regard to the rate variance for the half, but the negative impact was more pronounced. For the first half of 2011 relative to the first half of 2010 the weighted average cost of interest-bearing liabilities fell by 22 basis points, while the weighted average yield on earning assets was 50 basis points lower.

The Company's net interest margin for the first half of 2011 was 4.68%, a drop of 29 basis points relative to the net interest margin of 4.97% in the first half of 2010. For the half, negative forces include the shift into lower yielding investment securities and a 17 basis point drop in real estate loan yields. Positive developments include a shift from higher-cost CDARS and non-deposit borrowings into lower-cost core deposits, as well as a $25 million increase in average equity. Net interest recoveries were $71,000 for the first half of 2011, relative to net interest reversals of $405,000 in the first half of 2010.

PROVISION FOR LOAN AND LEASE LOSSES

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses through periodic charges to earnings, which are reflected in the income statement as the provision for loan losses. Those charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans, as well as probable incurred loan losses in the remaining loan portfolio.

The Company's provision for loan losses was reduced by $500,000, or 14%, in the second quarter of 2011 relative to the second quarter of 2010, and was $300,000 lower in the first half of 2011 than in the first half of 2010. The loan loss provision typically includes reserve replenishment subsequent to loan charge-offs, as well as the enhancement of general reserves for performing loans and specific reserves for impaired loans as needed pursuant to a detailed analysis of the adequacy of our allowance for loan and lease losses. Thus far in 2011, our loan loss provision has been utilized primarily to provide specific reserves for impaired loans and to replenish reserves subsequent to loan charge-offs. Balances transferred to non-accrual status totaled $20.6 million for the first half of 2011, although the net increase in non-accrual loans was only $1.2 million, and net loans charged off during the same period totaled $7.0 million relative to $5.7 million in the first half of 2010. The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed below in "Allowance for Loan and Lease Losses."

NON-INTEREST REVENUE AND OPERATING EXPENSE

The following table provides details on the Company's non-interest income and operating expense for the second quarter and first half of 2011 relative to the second quarter and first half of 2010:

Non Interest Income/Expense (dollars in thousands, unaudited)	For the Quarter Ended June 30,				For the Six Months Ended June 30,			
	2011	% of Total	2010	% of Total	2011	% of Total	2010	% of Total
OTHER OPERATING INCOME:								
Service charges on deposit accounts	$ 2,446	70.43 %	$ 2,887	72.37 %	$ 4,701	66.69 %	$ 5,590	71.21 %
Other service charges, commissions & fees	986	28.39 %	1,325	33.22 %	1,892	26.84 %	2,155	27.45 %
Gains on sales of loans	10	0.29 %	12	0.30 %	53	0.75 %	36	0.46 %
Gains on securities	-	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Loan servicing income	1	0.03 %	1	0.03 %	7	0.10 %	10	0.13 %
Bank owned life insurance	256	7.37 %	53	1.33 %	630	8.94 %	423	5.39 %
Other	(226)	-6.51 %	(289)	-7.25 %	(234)	-3.32 %	(364)	-4.64 %
Total non-interest income	3,473	100.00 %	3,989	100.00 %	7,049	100.00 %	7,850	100.00 %
As a % of average interest-earning assets (2)		1.16 %		1.35 %		1.21 %		1.34 %

OTHER OPERATING EXPENSES:								
Salaries and employee benefits	5,201	45.01 %	5,151	44.60 %	10,911	46.92 %	10,930	46.08 %
Occupancy costs								
Furniture & equipment	528	4.57 %	637	5.52 %	1,049	4.51 %	1,305	5.50 %
Premises	1,097	9.49 %	1,182	10.23 %	2,151	9.25 %	2,254	9.50 %
Advertising and marketing costs	494	4.28 %	555	4.81 %	916	3.94 %	1,077	4.54 %
Data processing costs	390	3.38 %	449	3.89 %	663	2.85 %	829	3.49 %
Deposit services costs	610	5.28 %	710	6.15 %	1,247	5.36 %	1,394	5.88 %
Loan services costs								
Loan processing	219	1.90 %	235	2.03 %	445	1.91 %	375	1.58 %
Foreclosed assets	1,100	9.52 %	650	5.63 %	1,724	7.41 %	1,289	5.43 %
Other operating costs								
Telephone & data communications	362	3.13 %	284	2.46 %	657	2.83 %	566	2.39 %
Postage & mail	145	1.25 %	143	1.24 %	286	1.23 %	285	1.20 %
Other	192	1.66 %	250	2.16 %	422	1.81 %	491	2.07 %
Professional services costs								
Legal & accounting	434	3.76 %	338	2.93 %	816	3.51 %	674	2.84 %
Other professional service	548	4.74 %	636	5.51 %	1,481	6.37 %	1,605	6.77 %
Stationery & supply costs	163	1.41 %	160	1.39 %	335	1.44 %	372	1.57 %
Sundry & tellers	72	0.62 %	168	1.45 %	154	0.66 %	275	1.16 %
Total non-interest Expense	$ 11,555	100.00 %	$ 11,548	100.00 %	$ 23,257	100.00 %	$ 23,721	100.00 %
As a % of average interest-earning assets (1)		3.87 %		3.91 %		3.99 %		4.04 %
Efficiency Ratio (2)	65.03 %		61.16 %		66.56 %		62.91 %	

(1) Annualized
(2) Tax Equivalent

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The Company's results reflect a decline in total non-interest income of $516,000, or 13%, for the second quarter of 2011 relative to the second quarter of 2010, and for the first half of 2011 the drop in non-interest income was $801,000, or 10%, relative to the first half of the prior year. As discussed in greater detail below, the decline in 2011 is due primarily to a large drop in overdraft income and a higher level of costs associated with low-income housing tax credit investments (which are accounted for as a reduction in income), which were partially offset by a higher level of debit card interchange income, higher merchant fees, an increase in income on bank-owned life insurance associated with deferred compensation plans, and gains on leased equipment subsequent to the termination of leases relative to losses in the prior year. Total other operating income was an annualized 1.16% of average interest-earning assets in the second quarter of 2011 relative to 1.35% in the second quarter of 2010, and was an annualized 1.21% of average earning assets for the first half of 2011 relative to 1.34% for the first half of 2010.

Service charge income on deposits declined by $441,000, or 15%, in the second quarter of 2011 relative to the second quarter of 2010, and fell by $889,000, or 16%, for the comparative year-to-date periods. Service charges were 0.55% of average transaction account balances in the second quarter of 2011 relative to 0.67% in the second quarter of 2010, and were 1.06% for the first half of 2011 in comparison to 1.35% in the first half of 2010. The drop was centered in overdraft income, with returned item and overdraft charges falling by $539,000, or 25%, for the second quarter, and by $1.034 million, or 25%, for the first half, primarily as the result of procedural changes implemented pursuant to new consumer-focused legislation and updated regulatory guidelines on overdrafts.

Other service charges, commissions, and fees were down $339,000, or 26%, for the quarter, and dropped by $263,000, or 12%, for the half, largely as the result of an increase in pass-through operating costs associated with our investment in low-income housing tax credit funds. Because we adjusted expense accruals for partnership losses on our tax credit investments in the second quarter of 2010 subsequent to the receipt of updated partnership financial statements, the accruals reflect declines in 2011 of $378,000 for the quarter and $374,000 for the half. Partially offsetting this were increases in debit card point-of-sale interchange fees of $79,000 for the quarter and $194,000 for the half, due to an increase in the number of active cards outstanding and increased per-card usage. Debit card interchange fees, which totaled $1.272 million in the first half of 2011, could be negatively impacted when the Durbin Amendment becomes effective in October of this year, although the potential dollar impact is difficult to predict. Merchant fees also increased in 2011, by $62,000 for the quarter and $98,000 for the first half.

There were no gains on securities in 2011 or 2010, and loan sale and servicing income remained at minimal levels. However, bank-owned life insurance income increased by $203,000, or 383%, in the second quarter of 2011 relative to the second quarter of 2010, and was up by $207,000, or 49%, for the first half of 2011 compared to the first half of 2010. The increases are due to fluctuations in income on BOLI associated with deferred compensation plans, which is classified as "separate account" BOLI. The Company owns and derives income from two basic types of BOLI: "general account," and "separate account." At June 30, 2011, the Company had $29.4 million invested in single-premium general account BOLI. Income from our general account BOLI is used to fund expenses associated with executive salary continuation plans and director retirement plans, and is typically fairly consistent with interest credit rates that do not change frequently. In addition to general account BOLI, the Company had $2.9 million invested in separate account BOLI at June 30, 2011, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses. This often results in significant fluctuations in income from period to period, and net gains on separate account BOLI totaled $9,000 in the second quarter of 2011 relative to a net loss of $203,000 in the second quarter of 2010, while for the year-to-date comparison net gains were $132,000 in 2011 relative to a net loss of $91,000 in 2011. As noted, gains and losses on separate account BOLI are related to participant gains and losses on deferred compensation balances. Participant gains are accounted for as expense accruals which, combined with their associated tax effect, effectively offset income on separate account BOLI, while participant losses result in expense accrual reversals that also effectively offset losses on separate account BOLI.

The "Other" category under non-interest income includes gains and losses on the disposition of real properties and other assets, and rental income generated by the Company's alliance with Investment Centers of America (ICA). Other non-interest income increased by $63,000, or 22%, in the second quarter of 2011 in comparison to the second quarter of 2010, and was up $130,000, or 36%, in the first half of 2011 relative to the first half of 2010, due mainly to gains on the disposition of leased equipment subsequent to the termination of leases in 2011, relative to losses in the prior year. For the second quarter, gains on leased equipment totaled $65,000 in 2011 relative to losses of $8,000 in 2010, and for the first six months, gains were $13,000 in 2011 relative to losses of $112,000 in 2010. While slightly lower in 2011, losses on the sale of OREO also impacted all of the comparative periods, with net losses totaling $313,000 in the second quarter of 2011 and $296,000 in the first half of 2011, in comparison to net losses of $328,000 in the second quarter of 2010 and $337,000 in the first half of 2010.

Total operating expense (non-interest expense) was $11.555 million for the quarter ended June 30, 2011, a negligible change relative to total operating expense for the second quarter of 2010. As detailed below, a sizeable increase in OREO write-downs for the quarter was offset by lower occupancy expense, lower deposit costs, and smaller declines in several other expense categories. Non-interest expense fell slightly to an annualized 3.87% of average interest-earning assets for the second quarter of 2011 from 3.91% in the second quarter of 2010. For the comparative year-to-date periods, non-interest expense fell by $464,000, or 2%, since the favorable variances in occupancy costs and various other expense categories exceeded the increase in foreclosed asset expense. Non-interest expenses were an annualized 3.99% of average earning assets for the first half of 2011, relative to 4.04% in the first half of 2010.

The largest component of non-interest expense, salaries and employee benefits, increased by only $50,000, or 1%, for the quarter, and fell slightly for the first six months despite the addition of staff for newer branches and increases in deferred compensation expense of $120,000 and $126,000 for the quarter and the half, respectively. Personnel expense has been well-controlled primarily because of a slight reduction in staffing: The Company had 381 full-time equivalent employees at June 30, 2011, down from 397 at June 30, 2010. Due to relatively large declines in other expense categories, salaries and benefits increased slightly to 45.01% of total non-interest expense for the second quarter of 2011 from 44.60% in the second quarter of 2010, and to 46.92% for the first half of 2011 from 46.08% in the first half of 2010.

Occupancy expense dropped by $194,000, or 11%, for the quarter, and by $359,000, or 10%, for the half, due mainly to a drop in depreciation expense, lower maintenance/repair costs, and the January 2011 closure of a branch with a relatively costly lease. Marketing costs also declined by $61,000, or 11%, for the second quarter, and by $161,000, or 15%, for the half, although the drop was due to the timing of payments and does not represent a permanent decline. Data processing costs were down as well, decreasing by $59,000, or 13%, for the second quarter, and $166,000, or 20%, for the comparative year-to-date periods. The decline for the quarter was primarily due to lower internet banking costs, while the difference for the first half was due mainly to $181,000 in non-recurring vendor credits for prior-year overcharges on processing software, which were received in the first quarter of 2011. Deposit services costs declined $100,000, or 14%, for the second quarter, and were down $147,000, or 11%, for the year-to-date comparison, due primarily to lower costs associated with our online deposit products. Loan processing costs reflect a small decline for the second quarter but were up by $70,000, or 19%, for the first half, due primarily to increases in costs related to appraisals and collections.

Foreclosed asset costs increased by $450,000, or 69%, for the quarter, and were $435,000, or 34%, higher for the first half, due to an increase in OREO write-downs. Write-downs on OREO totaled $847,000 in the second quarter of 2011 relative to $346,000 in the second quarter of 2010, and were $1.305 million for the first six months of 2011, relative to $613,000 in the first six months of 2010. For the year-to-date period, a reduction of $217,000 in foreclosed asset operating expenses helped partially offset the increase in write-downs. Foreclosed asset operating expenses totaled $253,000 in the second quarter of 2011 as compared to $265,000 in the second quarter of 2010, and were $418,000 in the first half of 2011 relative to $636,000 in the first half of 2010.

Telecommunications costs increase by $78,000 for the quarter and $91,000 for the first half due to the addition and enhancement of data circuits, as well as fluctuations in the timing of payments. The drop in the “other” category under other operating costs for the quarter and year-to-date periods is from lower depreciation expense on operating leases, where the Bank is the lessor. Under professional services costs, legal and accounting costs increased in 2011due in large part to consulting costs which were necessitated by the numerous changes in regulatory expectations and the associated promulgation of new guidance, as referenced above. The cost of other professional services declined, however, since increases in directors deferred compensation accruals, which are related to the increase in BOLI income as discussed above, were more-than-offset by lower FDIC assessments and lower accruals for directors fee continuation plans. Our accruals for FDIC assessments totaled $951,000 in the first half of 2011 relative to $1.118 million in the first half of 2010. The accrual for the first half of 2011 is close to our expectation for FDIC assessments going forward, although no assurance can be provided in that regard. Sundry losses were down $96,000 for the comparative quarters and $121,000 for the year-to-date comparison, due mainly to a non-recurring settlement of $75,000 paid to a customer in the second quarter of 2010, for a fraud loss on a deposit account.

Because income fell by a relatively greater amount than non-interest expense, the Company's tax-equivalent overhead efficiency ratio increased to 65.03% in the second quarter of 2011 from 61.16% in the second quarter of 2010, and to 66.56% for the first half of 2011 from 62.91% for the first half of 2010. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains/losses, and other extraordinary gains/losses excluded from the equation.

PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company's statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. Our tax credits consist primarily of those generated by a $9.6 million investment in low-income housing tax credit funds, and California state employment tax credits. Our provision for income taxes was only 9.6% of pre-tax income in the second quarter of 2011 relative to 18.2% in the second quarter of 2010, and we had a negative income tax provision for the first half of 2011 relative to a provision of 14.3% of pre-tax income for the first half of 2010. The lower provision in 2011 is primarily the result of the level of tax credits relative to our tax liability, and the favorable impact of tax-exempt interest income and BOLI income on that tax liability. As is evident, our tax accrual rate is currently very sensitive to changes in pretax income.

BALANCE SHEET ANALYSIS

EARNING ASSETS

INVESTMENTS

The major components of the Company's earning asset base are its investments and loans, and the detailed composition and growth characteristics of both are significant determinants of the financial condition of the Company. The Company's investments are analyzed in this section, while the loan and lease portfolio is discussed in a later section of this Form 10-Q.

The Company's investments consist of debt and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank account, and overnight fed funds sold. Surplus Federal Reserve Bank balances and fed funds sold to correspondent banks represent the investment of temporary excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments were 31% of total assets at June 30, 2011, compared to 26% at December 31, 2010.

We had no fed funds sold at June 30, 2011, relative to $210,000 at December 31, 2010. Our balance of interest-bearing balances at other banks exceeded $19 million at June 30, 2011, however, up from only $325,000 at the end of 2010, primarily because excess balance sheet liquidity was placed in our Federal Reserve Bank account at higher yields than could be realized by selling fed funds. Surplus liquidity, which was generated during the quarter from growth in deposits and loan runoff, was also deployed into longer-term, higher-yielding agency-issued mortgage-backed securities and municipal bonds, hence the book balance of the Company's investment portfolio increased by $71 million, or 21%, during the first six months of 2011. The book balance of our investment securities was $403 million at June 30, 2011. 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 value, with monthly tax-effected "mark-to-market" adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity. The following table sets forth the Company's investment portfolio by investment type as of the dates noted:

Investment Portfolio (dollars in thousands, unaudited)	June 30, 2011		December 31, 2010	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Available for Sale				