Oak Valley Bancorp
Form 10-Q
August 08, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

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

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

Issuer's telephone number

Not applicable

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

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

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

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
(Do not check if a smaller reporting company)	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,183,005 shares of common stock outstanding as of August 1, 2018.

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PART I – FINANCIAL STATEMENTS

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands)	June 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$158,775	$142,968
Federal funds sold	7,535	6,205
Cash and cash equivalents	166,310	149,173
Securities - available for sale	204,713	179,248
Securities - equity investments	3,068	3,112
Loans, net of allowance for loan loss of $8,162 and $8,166 at June 30, 2018 and December 31, 2017, respectively	645,136	652,989
Cash surrender value of life insurance	18,768	18,517
Bank premises and equipment, net	15,020	14,478
Other real estate owned	0	253
Goodwill and other intangible assets, net	3,999	4,056
Interest receivable and other assets	12,586	13,026
	$1,069,600	$1,034,852
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$970,615	$938,882
Interest payable and other liabilities	4,840	5,203
Total liabilities	975,455	944,085
Shareholders' equity		
Common stock, no par value; 50,000,000 shares authorized, 8,183,005 and 8,098,605 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	25,422	24,773
Additional paid-in capital	3,134	3,576
Retained earnings	65,606	61,429
Accumulated other comprehensive (loss) income, net of tax	(17)	989
Total shareholders' equity	94,145	90,767
	$1,069,600	$1,034,852

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(dollars in thousands, except per share amounts)	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2018	2017	2018	2017
INTEREST INCOME				
Interest and fees on loans	$7,628	$7,230	$15,199	$14,152
Interest on securities	1,417	1,102	2,645	2,176
Interest on federal funds sold	47	21	84	36
Interest on deposits with banks	594	372	1,166	672
Total interest income	9,686	8,725	19,094	17,036
INTEREST EXPENSE				
Deposits	359	270	650	499
Total interest expense	359	270	650	499
Net interest income	9,327	8,455	18,444	16,537
Provision for loan losses	0	35	0	35
Net interest income after provision for loan losses	9,327	8,420	18,444	16,502
OTHER INCOME				
Service charges on deposits	368	351	738	686
Debit card transaction fee income	304	278	582	542
Earnings on cash surrender value of life insurance	126	128	251	256
Mortgage commissions	33	37	65	99
Gains on sales and calls of securities	7	1	77	390
Gain on sale of OREO	0	0	193	0
Other	173	1,241	437	1,534
Total non-interest income	1,011	2,036	2,343	3,507
OTHER EXPENSES				
Salaries and employee benefits	4,076	3,457	8,095	7,069
Occupancy expenses	988	817	1,875	1,673
Data processing fees	426	409	842	755
Regulatory assessments (FDIC & DBO)	114	136	228	280
Other operating expenses	1,301	1,257	2,597	2,506
Total non-interest expense	6,905	6,076	13,637	12,283
Net income before provision for income taxes	3,433	4,380	7,150	7,726

Total provision for income taxes	842	1,550	1,757	2,689
Net Income	$2,591	$2,830	$5,393	$5,037
Net income per share	$0.32	$0.35	$0.67	$0.63
Net income per diluted share	$0.32	$0.35	$0.67	$0.62

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	THREE MONTHS ENDED JUNE 30, 2018	2017	SIX MONTHS ENDED JUNE 30, 2018	2017
Net income	$2,591	$2,830	$5,393	$5,037
Other comprehensive income:				
Unrealized gains on securities:				
Unrealized holding (losses) gains arising during the period	(243)	1,990	(1,583)	3,029
Less: reclassification for net gains included in net income	(7)	(1)	(77)	(390)
Other comprehensive (loss) gain, before tax	(250)	1,989	(1,660)	2,639
Tax benefit (expense) related to items of other comprehensive income	74	(819)	491	(1,086)
Total other comprehensive (loss) gain	(176)	1,170	(1,169)	1,553
Comprehensive income	$2,415	$4,000	$4,224	$6,590

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

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OAK VALLEY BANCORP

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

	YEAR ENDED DECEMBER 31, 2017 AND SIX MONTHS ENDED JUNE 30, 2018					
	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	Total Shareholders'
(dollars in thousands)	Shares	Amount	Capital	Earnings	Income (Loss)	Equity
Balances, January 1, 2017	8,088,455	$24,682	$ 3,473	$54,520	$ (225)	$ 82,450
Stock options exercised	9,000	91				91
Restricted stock issued	8,000					0
Restricted stock forfeited	(6,850)					0
Cash dividends declared				(2,022)		(2,022)
Stock based compensation			103			103
Other comprehensive income					1,051	1,051
DTA remeasurement reclassification				(163)	163	0
Net income				9,094		9,094
Balances, December 31, 2017	8,098,605	$24,773	$ 3,576	$61,429	$ 989	$ 90,767
Restricted stock issued	84,400					0
Cash dividends declared				(1,053)		(1,053)
Stock based compensation			207			207
APIC reclassification		649	(649)			0
Other comprehensive loss					(1,169)	(1,169)
Reclassification from adoption of ASU 2016-01				(163)	163	0
Net income				5,393		5,393
Balances, June 30, 2018	8,183,005	$25,422	$ 3,134	$65,606	$ (17)	$ 94,145

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(dollars in thousands)	SIX MONTHS ENDED JUNE 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$5,393	$5,037
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	0	35
(Decrease) increase in deferred fees/costs, net	(93)	77
Depreciation	617	560
Amortization of investment securities, net	538	393
Stock based compensation	207	55
Gain on sale of OREO property	(193)	0
Gain on sale of available for sale security	(70)	0
Earnings on cash surrender value of life insurance	(251)	(256)
(Decrease) increase in interest payable and other liabilities	(363)	1,042
Increase in interest receivable	(142)	(58)
Decrease (Increase) in other assets	1,438	(37)
Net cash from operating activities	7,081	6,848
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(38,101)	(16,023)
Purchases of equity securities	(43)	(41)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	10,515	3,782
Gain on calls of available for sale securities	(7)	(390)
Net decrease (increase) in loans	7,946	(13,090)
Purchase of FHLB Stock	(222)	(340)
Proceeds from sale of OREO	447	0
Purchases of premises and equipment	(1,159)	(95)
Net cash used in investing activities	(20,624)	(26,197)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Shareholder cash dividends paid	(1,053)	(1,011)
Net increase in demand deposits and savings accounts	36,400	14,602
Net decrease in time deposits	(4,667)	(2,909)
Proceeds from sale of common stock and exercise of stock options	0	16
Net cash from financing activities	30,680	10,698
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	17,137	(8,651)
CASH AND CASH EQUIVALENTS, beginning of period	149,173	190,810

CASH AND CASH EQUIVALENTS, end of period	$166,310	$182,159
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$651	$500
Income taxes	$2,200	$2,087
NON-CASH INVESTING ACTIVITIES:		
Change in unrealized (loss) gain on securities	$(1,747)	$2,640

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

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OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION

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

The consolidated financial statements include the accounts of the parent company and its wholly-owned bank subsidiary. Unless otherwise stated, the “Company” refers to the consolidated entity, Oak Valley Bancorp, while the “Bank” refers to Oak Valley Community Bank. All material intercompany transactions have been eliminated. In the opinion of management, the consolidated financial statements contain all adjustments necessary to present fairly the financial position, results of operations, changes in shareholders’ equity and cash flows. All adjustments are of a normal, recurring nature. The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results of a full year’s operations. Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders’ equity as a result of reclassifications. For further information, refer to the audited consolidated financial statements and footnotes included in the Company’s Form 10-K for the year ended December 31, 2017.

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

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

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount and at a time that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Subsequent updates related to Revenue from Contracts with Customers (Topic 606) are as follows:

August 2015 ASU No. 2015-14 - Deferral of the Effective Date, institutes a one-year deferral of the effective date of this amendment to annual reporting periods beginning after December 15, 2017. Early application is permitted only as of annual periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

March 2016 ASU No. 2016-08 - Principal versus Agent Considerations (Reporting Revenue Gross versus Net), clarifies the implementation guidance on principal versus agent considerations and on the use of indicators that assist an entity in determining whether it controls a specified good or service before it is transferred to the customer.

April 2016 ASU No. 2016-10 - Identifying Performance Obligations and Licensing, provides guidance in determining performance obligations in a contract with a customer and clarifies whether a promise to grant a license provides a right to access or the right to use intellectual property.

May 2016 ASU No. 2016-12 - Narrow Scope Improvements and Practical Expedients, gives further guidance on assessing collectability, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition.

Topic 606 was adopted by the Company on January 1, 2018 and did not have a material impact on the Company's consolidated financial statements. No additional disaggregated revenue disclosures are necessary because interest income sources are scoped out and there are no additional significant noninterest income sources to break out on the consolidated statement of income.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments - Overall (Subtopic 825-10)*: Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASU make improvements to GAAP related to financial instruments that include the following as applicable to us.

Equity investments, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee, are required to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment - if impairment exists, this requires measuring the investment at fair value.

Eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is currently required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Public companies will be required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements.

The reporting entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

ASU 2016-01 is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU was adopted by the Company on January 1, 2018 and impacted our financial statement disclosures, however, it did not have a material impact on our financial condition or results of operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842).* This ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities, including leases classified as operating leases under previous GAAP, on the balance sheet and requiring additional disclosures of key information about leasing arrangements. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective approach to adoption. Early application of the ASU is permitted. While the Company has not quantified the impact to its balance sheet, it does expect the adoption of this ASU will result in a gross-up in its balance sheet as a result of recording a right-of-use asset and a lease liability for each lease.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326).* This update changes the methodology used by financial institutions under current U.S. GAAP to recognize credit losses in the financial statements. Currently, U.S. GAAP requires the use of the incurred loss model, whereby financial institutions recognize in current period earnings, incurred credit losses and those inherent in the financial statements, as of the date of the balance sheet. This guidance results in a new model for estimating the allowance for loan and lease losses, commonly referred to as the Current Expected Credit Loss ("CECL") model. Under the CECL model, financial institutions are required to estimate future credit losses and recognize those losses in current period earnings. The amendments within the update are effective for fiscal years and all interim periods beginning after December 15, 2019, with early adoption permitted. Upon adoption of the amendments within this update, the Company will be required to make a cumulative-effect adjustment to the opening balance of retained earnings in the year of adoption. The Company is currently in the process of evaluating the impact the adoption of this update will have on its financial statements. While the Company has not quantified the impact of this ASU, it does expect changing from the current incurred loss model to an expected loss model will result in an earlier recognition of losses.

In February 2018, the FASB issued ASU 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. The ASU was issued to address certain stranded tax effects in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act of 2017. The ASU provides companies the option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change from the newly enacted corporate tax rate is recorded. The amount of the reclassification would be calculated on the basis of the difference between the historical and newly enacted tax rates for deferred tax liabilities and assets related to items within accumulated other comprehensive income. The ASU requires companies to disclose its accounting policy related to releasing income tax effects from accumulated other comprehensive income, whether it has elected to reclassify the stranded tax effects, and information about the other income tax effects that are reclassified. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods, therein, and early adoption is permitted for public business entities for which financial statements have not yet been issued. As of December 31, 2017, the Company adopted the ASU and made a reclassification adjustment from accumulated other comprehensive income to retained earnings on the Consolidated Statements of Shareholders' Equity, related to the stranded tax effects due to the change in the federal corporate tax rate applied on the unrealized gains (losses) on investments on a portfolio basis, to reflect the provisions of this ASU.

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NOTE 3 – SECURITIES

Equity Securities

The Company held equity securities with fair values of $3,068,000 and $3,112,000 at June 30, 2018 and December 31, 2017, respectively. There were no sales of equity securities during the three and six months ended June 30, 2018. Consistent with ASU 2016-01, these securities are carried at fair value with the changes in fair value recognized in the consolidated statement of income. Accordingly, the Company recognized an unrealized loss of $87,000 during the six months ended June 30, 2018.

Debit Securities

Debt securities have been classified in the financial statements as available for sale. The amortized cost and estimated fair values of debt securities as of June 30, 2018 are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 45,937	$ 180	$ (550)	$ 45,567
Collateralized mortgage obligations	2,300	0	(74)	2,226
Municipalities	91,370	1,387	(459)	92,298
SBA pools	10,233	19	(62)	10,190
Corporate debt	21,426	172	(775)	20,823
Asset backed securities	33,471	206	(68)	33,609
	$ 204,737	$ 1,964	$ (1,988)	$ 204,713

The following tables detail the gross unrealized losses and fair values of debt securities aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2018.

(dollars in thousands)	Less than 12 months		12 months or more		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Description of Securities	Value	Loss	Value	Loss	Value	Loss
U.S. agencies	$30,239	$ (324)	$4,981	$ (226)	$35,220	$ (550)
Collateralized mortgage obligations	457	(1)	1,768	(73)	2,225	(74)
Municipalities	30,899	(335)	7,407	(124)	38,306	(459)
SBA pools	6,337	(56)	613	(6)	6,950	(62)
Corporate debt	3,991	(72)	11,786	(703)	15,777	(775)
Asset backed securities	12,290	(61)	1,980	(7)	14,270	(68)
Total temporarily impaired securities	$84,213	$ (849)	$28,535	$ (1,139)	$112,748	$ (1,988)

At June 30, 2018, there were nine corporate debts, eight municipalities, four U.S. agencies, two SBA pools, two asset backed securities and two collateralized mortgage obligation that comprised the total debt securities in an unrealized loss position for greater than 12 months and forty-three municipalities, twenty-one U.S. agencies, seven asset backed securities, four SBA pools, two collateralized mortgage obligations, and two corporate debts that make up the total debt securities in a loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

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The amortized cost and estimated fair value of debt securities at June 30, 2018, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands)	**Amortized Cost**	**Fair Value**
Available-for-sale securities:		
Due in one year or less	$ 30,437	$ 30,676
Due after one year through five years	52,211	52,008
Due after five years through ten years	51,071	51,010
Due after ten years	71,018	71,019
	$ 204,737	$ 204,713

The amortized cost and estimated fair values of debt securities as of December 31, 2017, are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 29,741	$ 374	$ (143)	$ 29,972
Collateralized mortgage obligations	2,628	1	(36)	2,593
Municipalities	91,201	2,174	(308)	93,067
SBA pools	11,818	46	(14)	11,850
Corporate debt	19,358	112	(681)	18,789
Asset backed securities	22,866	125	(14)	22,977
	$ 177,612	$ 2,832	$ (1,196)	$ 179,248

The following tables detail the gross unrealized losses and fair values of debt securities aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2017.

(dollars in thousands)	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	**Fair**	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**

	Value	Loss	Value	Loss	Value	Loss
U.S. agencies	$10,588	$ (46)	$5,437	$ (97)	$16,025	$ (143)
Collateralized mortgage obligations	1,090	(11)	921	(26)	2,011	(37)
Municipalities	28,779	(236)	5,611	(72)	34,390	(308)
SBA pools	1,998	(4)	703	(9)	2,701	(13)
Corporate debt	1,994	(6)	13,815	(675)	15,809	(681)
Asset backed securities	6,154	(13)	333	(1)	6,487	(14)
Total temporarily impaired securities	$50,603	$ (316)	$26,820	$ (880)	$77,423	$ (1,196)

We recognized gross gains of $7,000 for the three and six month periods ended June 30, 2018, on certain available-for-sale securities that were called, which compares to $1,000 and $390,000 in the same periods of 2017. There was one sale of a municipal bond resulting in a gain of $70,000 during the first six months of 2018, compared to no sales during the same period of 2017.

Debt securities carried at $116,582,000 and $109,158,000 at June 30, 2018 and December 31, 2017, respectively, were pledged to secure deposits of public funds.

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NOTE 4 – LOANS

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of June 30, 2018, approximately 78% of the Company's loans are commercial real estate loans which include construction loans. Approximately 11% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 5% of the Company's loans are for residential real estate and other consumer loans. The remaining 6% are agriculture loans. Loan totals were as follows:

(in thousands)	June 30, 2018	December 31, 2017
Commercial real estate:		
Commercial real estate- construction	$25,001	$31,265
Commercial real estate- mortgages	415,301	417,138
Land	10,753	10,072
Farmland	51,601	58,675
Commercial and industrial	75,561	69,610
Consumer	724	689
Consumer residential	37,277	37,161
Agriculture	38,376	37,934
Total loans	654,594	662,544
Less:		
Deferred loan fees and costs, net	(1,296)	(1,389)
Allowance for loan losses	(8,162)	(8,166)
Net loans	$645,136	$652,989

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

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company’s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company’s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At June 30, 2018 and December 31, 2017, commercial real estate loans equal to approximately 42% and 43%, respectively, of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

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

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

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

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

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

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

(in thousands)	June 30, 2018	December 31, 2017
Commercial real estate:		
Land	$993	$ 993
Commercial and industrial	302	302
Consumer residential	15	16
Total non-accrual loans	$1,310	$ 1,311

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately $19,000 and $37,000 in the three and six month periods ended June 30, 2018, respectively, as compared to $31,000 and $68,000 in the same periods of 2017.

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The following table analyzes past due loans including the past due non-accrual loans in the above table, segregated by class of loans, as of June 30, 2018 (in thousands):

June 30, 2018	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing
Commercial real estate:							
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 25,001	$ 25,001	$ 0
Commercial R.E. - mortgages	0	0	0	0	415,301	415,301	0
Land	0	0	993	993	9,760	10,753	0
Farmland	0	0	0	0	51,601	51,601	0
Commercial and industrial	0	0	302	302	75,259	75,561	0
Consumer	0	0	0	0	724	724	0
Consumer residential	17	0	0	17	37,260	37,277	0
Agriculture	0	0	0	0	38,376	38,376	0
Total	$ 17	$ 0	$ 1,295	$ 1,312	$ 653,282	$ 654,594	$ 0

The following table analyzes past due loans including the past due non-accrual loans in the above table, segregated by class of loans, as of December 31, 2017 (in thousands):

December 31, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing

Commercial real estate:							
Commercial R.E. - construction	$ 0	$ 0	$0	$0	$31,265	$31,265	$ 0
Commercial R.E. - mortgages	0	0	0	0	417,138	417,138	0
Land	0	0	993	993	9,079	10,072	0
Farmland	0	0	0	0	58,675	58,675	0
Commercial and industrial	19	0	302	321	69,289	69,610	0
Consumer	0	0	0	0	689	689	0
Consumer residential	0	0	0	0	37,161	37,161	0
Agriculture	0	0	0	0	37,934	37,934	0
Total	$ 19	$ 0	$1,295	$1,314	$661,230	$662,544	$ 0

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. There was no interest income realized on impaired loans for the three and six months ended June 30, 2018 and 2017.

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Impaired loans as of June 30, 2018 and December 31, 2017 are set forth in the following tables.

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
June 30, 2018					
Commercial real estate:					
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	1,309	0	993	993	680
Farmland	0	0	0	0	0
Commercial and Industrial	334	302	0	302	0
Consumer	0	0	0	0	0
Consumer residential	15	15	0	15	0
Agriculture	0	0	0	0	0
Total	$ 1,658	$ 317	$ 993	$ 1,310	$ 680

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
December 31, 2017						
Commercial real estate:						
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0	0
Land	1,309	0	993	993	680	1,760
Farmland	0	0	0	0	0	0
Commercial and Industrial	334	302	0	302	0	303
Consumer	0	0	0	0	0	0
Consumer residential	16	16	0	16	0	76
Agriculture	0	0	0	0	0	0
Total	$ 1,659	$ 318	$ 993	$ 1,311	$ 680	$ 2,139

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

At June 30, 2018, there were 4 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $1,310,000. At December 31, 2017, there were 4 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $1,311,000. At June 30, 2018 and December 31, 2017 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated $680,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of June 30, 2018 and December 31, 2017.

The modification of the terms of such loans typically includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan is conceded.

During the three and six months ended June 30, 2018 and 2017, no loans were modified as troubled debt restructurings. There were no loans modified as troubled debt restructurings within the previous twelve months and for which there was a payment default during the three and six month periods ended June 30, 2018 and 2017. A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

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

We grade loans using the following letter system:

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

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

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

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

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

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

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

-Consistent strong earnings.

-A solid equity base.

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

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

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

-The loan has no exceptions to policy.

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

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

-Little to no debt on balance sheet.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

As of June 30, 2018 and December 31, 2017, there are no loans that are classified with a risk grade of *8- Loss.*

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

	June 30, 2018 Weighted Average Risk Grade	December 31, 2017 Weighted Average Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.00	3.08
Commercial real estate - mortgages	3.00	3.01
Land	3.66	3.71
Farmland	3.00	3.14
Commercial and industrial	3.08	3.09
Consumer	2.02	2.34
Consumer residential	3.01	3.01
Agriculture	3.12	3.19
Total gross loans	3.02	3.05

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The following table presents risk grade totals by class of loans as of June 30, 2018 and December 31, 2017. Risk grades 1 through 4 have been aggregated in the "Pass" line.

(in thousands)	Commercial R.E. Construction	Commercial R.E. Mortgages	Land	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
June 30, 2018									
Pass	$ 25,001	$ 414,609	$ 9,588	$ 51,601	$ 71,826	$ 697	$ 37,219	$ 38,376	$ 648,917
Special mention	-	-	-	-	3,433	-	-	-	3,433
Substandard	-	692	1,165	-	302	27	58	-	2,244
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 25,001	$ 415,301	$ 10,753	$ 51,601	$ 75,561	$ 724	$ 37,277	$ 38,376	$ 654,594
December 31, 2017									
Pass	$ 30,008	$ 416,437	$ 8,901	$ 58,675	$ 65,313	$ 662	$ 37,100	$ 37,934	$ 655,030
Special mention	1,257	-	-	-	3,762	-	-	-	5,019
Substandard	-	701	1,171	-	535	27	61	-	2,495
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 31,265	$ 417,138	$ 10,072	$ 58,675	$ 69,610	$ 689	$ 37,161	$ 37,934	$ 662,544

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

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

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Bank and the Company; and (iv) unallocated allowance which represents the excess allowance not allocated to specific loans pools.

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

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

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

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

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

The following table details activity in the allowance for loan losses by portfolio segment for the three and six months ended June 30, 2018 and 2017. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

Allowance for Loan Losses
For the Three Months Ended March 31, 2018 and 2017

(in thousands) **Three Months Ended June 30, 2018**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,138	$ 808	$ 22	$ 297	$ 678	$ 222	$8,165
Charge-offs	0	0	(6)	0	0	0	(6)
Recoveries	0	0	3	0	0	0	3
Provision for (reversal of) loan losses	(116)	65	3	7	20	21	0
Ending balance	$ 6,022	$ 873	$ 22	$ 304	$ 698	$ 243	$8,162

Six Months Ended June 30, 2018	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	Total
Beginning balance	$6,331	$ 813	$ 27	$ 300	$ 693	$ 2	$8,166
Charge-offs	0	0	(10)	0	0	0	(10)
Recoveries	0	0	5	1	0	0	6
Provision for (reversal of) loan losses	(309)	60	0	3	5	241	0
Ending balance	$6,022	$ 873	$ 22	$ 304	$ 698	$ 243	$8,162

(in thousands) **Three Months Ended June 30, 2017**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,266	$ 735	$ 37	$ 310	$ 447	$ 32	$7,827
Charge-offs	-	-	(10)	-	-	-	(10)
Recoveries	-	-	1	1	-	-	2
Provision for (reversal of) loan losses	(19)	11	2	10	6	25	35
Ending balance	$ 6,247	$ 746	$ 30	$ 321	$ 453	$ 57	$7,854

Six Months Ended June 30, 2017	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	Total
Beginning balance	$6,185	$ 697	$ 51	$ 325	$ 504	$ 70	$7,832
Charge-offs	-	-	(17)	-	-	-	(17)
Recoveries	-	-	3	1	-	-	4
Provision for (reversal of) loan losses	62	49	(7)	(5)	(51)	(13)	35
Ending balance	$6,247	$ 746	$ 30	$ 321	$ 453	$ 57	$7,854

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The following table details the allowance for loan losses and ending gross loan balances as of June 30, 2018, December 31, 2017 and June 30, 2017 summarized by collective and individual evaluation methods of impairment.

(in thousands)	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
June 30, 2018							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,342	873	22	304	698	243	7,482
	$ 6,022	$ 873	$ 22	$ 304	$ 698	$ 243	$ 8,162
Ending gross loan balances:							
Individually evaluated for impairment	$ 993	$ 302	$ 0	$ 15	$ 0	$ 0	$ 1,310
Collectively evaluated for impairment	501,663	75,259	724	37,262	38,376	0	653,284
	$ 502,656	$ 75,561	$ 724	$ 37,277	$ 38,376	$ 0	$ 654,594
December 31, 2017							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,651	813	27	300	693	2	7,486
	$ 6,331	$ 813	$ 27	$ 300	$ 693	$ 2	$ 8,166
Ending gross loans balances:							
Individually evaluated for impairment	$ 993	$ 303	$ 0	$ 15	$ 0	$ 0	$ 1,311
Collectively evaluated for impairment	516,157	69,307	689	37,146	37,934	0	661,233
	$ 517,150	$ 69,610	$ 689	$ 37,161	$ 37,934	$ 0	$ 662,544
June 30, 2017							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,567	746	30	321	453	57	7,174
	$ 6,247	$ 746	$ 30	$ 321	$ 453	$ 57	$ 7,854

Ending gross loan balances:							
Individually evaluated for impairment	$ 1,574	$ 304	$ 0	$ 154	$ 0	$ 0	$ 2,032
Collectively evaluated for impairment	493,448	63,550	684	39,147	24,948	0	621,777
	$ 495,022	$ 63,854	$ 684	$ 39,301	$ 24,948	$ 0	$ 623,809

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

	THREE MONTHS ENDED JUNE 30,		**SIX MONTHS ENDED JUNE 30,**	
	2018	**2017**	**2018**	**2017**
Balance, beginning of period	$ 368	$ 289	$ 305	$ 284
Provision to Operations for Off Balance Sheet Commitments	4	13	67	18
Balance, end of period	$ 372	$ 302	$ 372	$ 302

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

At June 30, 2018 and December 31, 2017, loans carried at $654,594,000 and $662,544,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

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NOTE 5 – OTHER REAL ESTATE OWNED

As of June 30, 2018, the Company owned one property classified as other real estate with no carrying value, as compared to two properties totaling $253,000 as of December 31, 2017. The property owned at June 30, 2018 and December 31, 2017, was a residential land property that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. This other real estate asset ("OREO") property and the other property owned at December 31, 2017 were acquired through loan foreclosures. During the six months ended June 30, 2018, there was one sale of an OREO property resulting in a gain on sale of $193,000, and there were no OREO property acquisitions. During the six months ended June 30, 2017, there were no acquisitions or sales of OREO properties.

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

NOTE 6 — GOODWILL AND OTHER INTANGIBLE ASSETS

Intangible assets are comprised of goodwill and core deposit intangibles that were acquired through a business combination. Intangible assets with definite useful lives are amortized over their respective estimated useful lives. If an event occurs that indicates the carrying amount of an intangible asset may not be recoverable, management reviews the asset for impairment. Any goodwill and any intangible asset acquired in a purchase business combination determined to have an indefinite useful life is not amortized, but is evaluated for impairment, at a minimum, on an annual basis.

The core deposit intangible represents the estimated future benefits of acquired deposits and is booked separately from the related deposits. The value of the core deposit intangible asset was determined using a discounted cash flow approach to arrive at the cost differential between the core deposits (non-maturity deposits such as transaction, savings and money market accounts) and alternative funding sources. The core deposit intangible is amortized on an accelerated basis over an estimated ten-year life, and it is evaluated periodically for impairment. No impairment loss was recognized as of June 30, 2018. At December 31, 2017, the core deposit intangibles future estimated amortization expense is as follows:

(in thousands)	2018	2019	2020	2021	2022	Thereafter	Total
Core deposit intangible amortization	$114	$105	$96	$93	$89	$ 236	$733

The Company applies a qualitative analysis of conditions in order to determine if it is more likely than not that the carrying value is impaired. In the event that the qualitative analysis suggests that the carrying value of goodwill may be impaired, the Company, with the assistance of an independent third party valuation firm, uses several quantitative valuation methodologies in evaluating goodwill for impairment including a discounted cash flow approach that includes assumptions made concerning the future earnings potential of the organization, and a market-based approach that looks at values for organizations of comparable size, structure and business model. The current year's review of qualitative factors did not indicate that impairment has occurred, as such no quantitative analysis was performed at June 30, 2018.

NOTE 7 — FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Fair values of financial instruments — The consolidated financial statements include various estimated fair value information as of June 30, 2018 and December 31, 2017. Such information, which pertains to the Company’s financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

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

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

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

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

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In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company’s quarterly valuation process. There were no transfers between levels during the three and six month periods ended June 30, 2018 or 2017.

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

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

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

Loans receivable — The fair value of our loan portfolio is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The Company’s fair value model takes into account many inputs including loan discounts due to credit risk, current market rates on new loans, the U.S. treasury yield curve, LIBOR yield curve, rate floors, rate ceilings, remaining maturity, and average life based on specific loan type. Adoption of ASU 2016-01 during the first quarter of 2018 resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis. Loans are considered to be a level 3 valuation.

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

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

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

The estimated fair values of the Company's financial instruments not measured at fair value at June 30, 2018 were as follows:

(in thousands)	**Carrying Amount**	**Fair Value**	**Hierarchy Valuation Level**
Financial assets:			
Cash and cash equivalents	$166,310	$166,310	1
Restricted equity securities	4,357	4,357	2
Loans, net	645,136	646,743	3
Interest receivable	3,313	3,313	2
Financial liabilities:			
Deposits	(970,615)	(970,112)	3
Interest payable	(44)	(44)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(1,446)	3

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The estimated fair values of the Company's financial instruments not measured at fair value at December 31, 2017 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$149,173	$149,173	1
Restricted equity securities	4,135	4,135	2
Loans, net	638,902	639,830	3
Interest receivable	3,170	3,170	2
Financial liabilities:			
Deposits	(938,882)	(829,992)	3
Interest payable	(45)	(45)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(1,180)	3

The following table presents the carrying value of recurring and nonrecurring financial instruments that were measured at fair value and that were still held in the condensed consolidated balance sheets at each respective period end, by level within the fair value hierarchy as of June 30, 2018 and December 31, 2017.

	Fair Value Measurements at June 30, 2018 Using			
(in thousands)	June 30, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	$45,567	$ 0	$ 45,567	$ 0
Collateralized mortgage obligations	2,226	0	2,226	0
Municipalities	92,298	0	92,298	0
SBA pools	10,190	0	10,190	0
Corporate debt	20,823	0	20,823	0

Asset backed securities	33,609	0	33,609	0
Equity Securities:*				
Mutual fund	$3,068	$ 3,068	$ 0	$ 0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	$313	$ 0	$ 0	$ 313
Commercial and industrial	302	0	0	302
Consumer residential	15	0	0	15

* Effective January 1, 2018, the Company adopted ASU 2016-01, which requires equity securities with readily determinable fair values to be measured at fair value with changes in the fair value recognized through net income. See Note 1 for additional information on this new accounting standard.

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(in thousands)	December 31, 2017	Fair Value Measurements at December 31, 2017 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	$29,972	$ 0	$ 29,972	$ 0
Collateralized mortgage obligations	2,593	0	2,593	0
Municipalities	93,067	0	93,067	0
SBA pools	11,850	0	11,850	0
Corporate debt	18,789	0	18,789	0
Asset backed securities	22,977	0	22,977	0
Equity Securities:*				
Mutual fund	$3,112	$ 3,112	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	$313	$ 0	$ 0	$ 313
Commercial and industrial	302	0	0	302
Consumer residential	16	0	0	16
Other real estate owned	253	0	0	253

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

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

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

Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis. No fair value adjustments were made to OREO properties during the six months ended June 30, 2018.

There have been no significant changes in the valuation techniques during the period ended June 30, 2018.

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NOTE 8 – EARNINGS PER SHARE

Earnings per share (“EPS”) are based upon the weighted average number of common shares outstanding during each year. The following table shows: (1) weighted average basic shares, (2) effect of dilutive securities related to stock options and non-vested restricted stock, and (3) weighted average shares of common stock and common stock equivalents. Net income available to common stockholders is calculated as net income reduced by dividends accumulated on preferred stock, if any. Basic EPS is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS is calculated using the weighted average diluted shares, which reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The dilutive shares included in year-to-date diluted EPS is a weighted average of the dilutive shares included in each quarterly diluted EPS computation under the treasury stock method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common stockholders and they both share equally in undistributed earnings. Therefore, under the two class method the difference in EPS is not significant for these participating securities.

The Company’s calculation of basic and diluted earnings per share (“EPS”) for the three and six month periods ended June 30, 2018 and 2017 are reflected in the table below.

(In thousands)	**THREE MONTHS ENDED JUNE 30,**	
	2018	**2017**
BASIC EARNINGS PER SHARE		
Net income	$2,591	$2,830
Weighted average shares outstanding	8,080	8,062
Net income per common share	$0.32	$0.35
DILUTED EARNINGS PER SHARE		
Net income	$2,591	$2,830
Weighted average shares outstanding	8,080	8,062
Effect of dilutive stock options	2	4
Effect of dilutive non-vested restricted shares	16	14
Weighted average shares of common stock and common stock equivalents	8,098	8,080
Net income per diluted common share	$0.32	$0.35

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(In thousands)	SIX MONTHS ENDED JUNE 30, 2018	2017
BASIC EARNINGS PER SHARE		
Net income	$5,393	$5,037
Weighted average shares outstanding	8,078	8,052
Net income per common share	$0.67	$0.63
DILUTED EARNINGS PER SHARE		
Net income	$5,393	$5,037
Weighted average shares outstanding	8,078	8,052
Effect of dilutive stock options	2	4
Effect of dilutive non-vested restricted shares	19	20
Weighted average shares of common stock and common stock equivalents	8,099	8,076
Net income per diluted common share	$0.67	$0.62

During the three and six month periods ended June 30, 2018 and 2017, there were no anti-dilutive options to purchase shares of common stock, and there were no anti-dilutive non-vested restricted stock grants during the same periods.

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear or that are referenced to elsewhere in this report, and with the audited consolidated financial statements and accompanying notes included in our 2017 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

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

Forward-Looking Statements

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

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

Critical Accounting Estimates

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

Allowance for Loan Losses

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

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

- the specific review of individual loans,
- the segmenting and review of loan pools with similar characteristics, and
- our judgmental estimate based on various subjective factors.

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

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

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

- concentration of credits,
- nature and volume of the loan portfolio,
- delinquency trends,
- non-accrual loan trend,
- problem loan trend,
- loss and recovery trend,
- quality of loan review,
- lending and management staff,
- lending policies and procedures,
- economic and business conditions, and

other external factors, including regulatory review.

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

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

Non-Accrual Loan Policy

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

Asset Impairment Judgments

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

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

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

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

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

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

Fair Value Measurements

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

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

Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company’s assets and liabilities. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled using the liability method. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files income tax returns in the U.S. federal jurisdiction, and the state of California. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2012.

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Introduction

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

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

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

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

Overview of Results of Operations and Financial Condition

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

Management believes the following were important factors in the Company's performance during the three and six month periods ended June 30, 2018:

- The Company recognized net income of $2,591,000 and $5,393,000 for the three and six month periods ended June 30, 2018, respectively, as compared to $2,830,000 and $5,037,000 for the same periods in 2017. The factors contributing to these results will be discussed below.

- The Company recognized no loan loss provisions during the three and six month periods ended June 30, 2018, as compared to $35,000 during the same periods of 2017. This variance corresponds to the gross loan decrease of $7,950,000 during the first six months of 2018, compared to loan growth of $12,978,000 during the first six months of 2017.

- Net interest income increased $872,000 or 10.3% and $1,907,000 or 11.5% for the three and six month periods ended June 30, 2018, respectively, compared to the same periods in 2017. The increase was primarily due to the organic growth of our loan and investment security portfolios.

- Non-interest income decreased by $1,025,000 or 50.3% and $1,164,000 or 33.2% for the three and six months ended June 30, 2018, respectively, as compared to the same periods in 2017, primarily due to non-recurring merger-related professional service provider settlement payments that were recorded in the prior year.

- Non-interest expense increased by $829,000 or 13.6% and $1,354,000 or 11.0% for the three and six month periods ended June 30, 2018, respectively, as compared to the same periods in 2017. The increase was mainly due to increased salaries and benefits, and other general operating expenses required to support the loan and deposit growth.

- Total assets increased $34,748,000 or 3.4% from December 31, 2017. Total net loans decreased by $7,853,000 or 1.2% and investment securities increased by $25,465,000 or 14.2% from December 31, 2017 to June 30, 2018, while deposits increased by $31,733,000 or 3.4% for the same period. Consequently, cash and cash equivalent balances increased due to the decline in gross loans, and the growth in deposits and shareholders' equity.

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Income Summary

For the three and six month periods ended June 30, 2018, the Company recorded net income of $2,591,000 and $5,393,000, respectively, representing increases of $239,000 and $356,000, as compared to the same periods in 2017. Return on average assets (annualized) was 0.99% and 1.03% for the three and six months ended June 30, 2018, respectively, as compared to 1.14% and 1.02% for the same periods in 2017. Annualized return on average common equity was 11.18% and 11.82% for the three and six months ended June 30, 2018, respectively, as compared to 13.14 and 11.96% for the same periods of 2017. Net income before provisions for income taxes decreased by $947,000 and $576,000 for the three and six month periods ended June 30, 2018, from the comparable 2017 periods. The income statement components of these variances are as follows:

Pre-Tax Income Variance Summary:

(In thousands)	**Effect on Pre-Tax Income** ***Increase (Decrease)*** **Three Months Ended June 30, 2018**	**Effect on Pre-Tax Income** ***Increase (Decrease)*** **Six Months Ended June 30, 2018**
Change from 2017 to 2018 in:		
Net interest income	$ 872	$ 1,907
Provision for loan losses	35	35
Non-interest income	(1,025)	(1,164)
Non-interest expense	(829)	(1,354)
Change in net income before income taxes	$ (947)	$ (576)

These variances will be explained in the discussion below.

Net Interest Income

Net interest income is the largest source of the Company's operating income. For the three and six month periods ended June 30, 2018, respectively, net interest income was $9,327,000 and $18,444,000, which represented increases of $872,000 or 10.3% and $1,907,000 or 11.5%, from the comparable periods in 2017. The increase is primarily due to loan and investment portfolio growth.

The net interest margin (net interest income as a percentage of average interest earning assets) was 3.83% and 3.82% for the three and six month periods ended June 30, 2018, respectively, compared to 3.74% and 3.72% for the same periods in 2017. The increase in net interest margin is primarily due to an increase in the average loan balance and yield on earning assets. In general, the Company has experienced net interest margin compression since the economic downturn in 2008 for several reasons: 1) deposit interest rates have essentially reached a threshold in which they cannot reasonably be further reduced, 2) competition in the lending market has driven new loan rates down and 3) deposit growth in recent years has resulted in high interest-bearing cash balances, which currently yield approximately 2.00%, has compressed our net interest margin.

Earning asset yield increased by 12 and 13 basis points for the three and six month periods ended June 30, 2018, respectively, as compared to the same periods of 2017, mainly due to an increase in loan volume, loan yield, and the yield on cash balances that has been recognized due to the recent FOMC rate hikes. Furthermore, the earning asset yield is trending upward as a result of deploying low yielding cash equivalent balances into the loan and investment portfolios which recognized average balance increases of $35 million and $30 million, respectively, in the six month period of 2018 as compared to 2017.

The cost of funds on interest-bearing liabilities increased by 5 and 3 basis points for the three and six month periods of 2018, respectively, as compared to the same periods in 2017, as deposit rates remain low and the banking industry has not reacted to the recent FOMC interest rate hikes thus far. The Company continues to recognize strong core deposit growth as evidenced by the increase in average non-interest-bearing demand deposit balances of $20 million, for the six month period ended June 30, 2018, as compared to the same period of 2017.

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The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three and six month periods ended June 30, 2018 and 2017:

Net Interest Analysis

(in thousands)	**Three Months Ended June 30, 2018**			**Three Months Ended June 30, 2017**		
	Average Balance	**Interest Income / Expense**	**Avg Rate/ Yield (5)**	**Average Balance**	**Interest Income / Expense**	**Avg Rate/ Yield (5)**
Assets:						
Earning assets:						
Gross loans (1) (2)	$644,619	$ 7,647	4.76 %	$617,590	$ 7,265	4.72 %
Investment securities (2)	204,514	1,571	3.08 %	170,267	1,367	3.22 %
Federal funds sold	10,649	47	1.77 %	8,258	21	1.02 %
Interest-earning deposits	134,082	595	1.78 %	142,162	370	1.04 %
Total interest-earning assets	993,864	9,860	3.98 %	938,277	9,023	3.86 %
Total noninterest earning assets	58,790			60,452		
Total Assets	1,052,654			998,729		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
Interest-earning DDA	231,015	107	0.19 %	201,172	84	0.17 %
Money market deposits	289,568	209	0.29 %	289,162	134	0.19 %
Savings deposits	72,882	9	0.05 %	65,823	8	0.05 %
Time certificates of deposit $250,000 or more	18,406	15	0.33 %	21,071	20	0.38 %
Other time deposits	27,450	19	0.28 %	32,095	24	0.30 %
Other borrowings	0	0	0.00 %	0	0	0.00 %
Total interest-bearing liabilities	639,321	359	0.23 %	609,323	270	0.18 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	314,920			297,598		
Other liabilities	5,490			5,403		
Total noninterest-bearing liabilities	320,410					