Oak Valley Bancorp
Form 10-Q
November 13, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2009

OR

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

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

California	**26-2326676**

State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

Issuer s telephone number

Not applicable

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

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 7,681,877 shares of common stock outstanding as of October 30, 2009.

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Oak Valley Bancorp

September 30, 2009

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PART I FINANCIAL STATEMENTS

Item 1. Financial Statements

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

AT SEPTEMBER 30, 2009 AND DECEMBER 31, 2008

		September 30, 2009		December 31, 2008
ASSETS				
Cash and due from banks	$	9,601,446	$	9,072,860
Federal funds sold		5,490,000		765,000
Cash and cash equivalents		15,091,446		9,837,860
Securities available for sale		53,564,662		41,448,877
Loans, net of allowance for loan loss of $6,396,367 in 2009 and $5,569,496 in 2008		418,122,087		421,572,911
Bank premises and equipment, net		10,370,313		11,093,967
Other real estate owned (OREO)		1,990,782		2,745,575
Accrued interest and other assets		22,039,878		21,503,821
	$	521,179,168	$	508,203,011
LIABILITIES AND SHAREHOLDERS EQUITY				
Deposits	$	431,532,833	$	378,248,467
Accrued interest and other liabilities		2,582,878		2,968,465
FHLB advances		27,000,000		69,000,000
Total liabilities		461,115,711		450,216,932
Shareholders equity				
Preferred stock, no par value; $1,000 per share liquidation preference, 10,000 shares authorized and 13,500 issued and outstanding at September 30, 2009 and December 31, 2009		12,805,635		12,680,649
Common stock, no par value; 10,000,000 shares authorized and 7,681,877 and 7,661,627 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively		23,933,441		23,863,331
Additional paid-in capital		1,981,624		1,925,224
Retained earnings		19,705,766		19,226,645
Accumulated other comprehensive income, net of tax		1,636,991		290,230
Total shareholders equity		60,063,457		57,986,079
	$	521,179,168	$	508,203,011

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2009 AND SEPTEMBER 30, 2008

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2009	2008	2009	2008
Interest and fees on loans	$ 6,736,602	$ 7,040,391	$ 20,048,818	$ 20,750,394
Interest on securities available for sale	678,379	403,064	1,967,059	1,205,973
Interest on federal funds sold	1,334	4,254	2,929	13,831
Interest on deposits with banks	1,942	566	3,574	1,592
Total interest income	7,418,257	7,448,275	22,022,380	21,971,790
Deposits	1,245,576	1,700,868	3,918,842	5,568,872
FHLB advances	152,841	455,441	539,979	1,214,339
Federal funds purchased	38	238	381	7,554
Total interest expense	1,398,455	2,156,547	4,459,202	6,790,765
Net interest income	6,019,802	5,291,728	17,563,178	15,181,025
Provision for loan losses	925,000	602,000	4,962,012	1,187,000
Net interest income after provision for loan losses	5,094,802	4,689,728	12,601,166	13,994,025
Service charges on deposits	300,282	337,264	875,229	984,556
Earnings on cash surrender value of life insurance	101,057	99,241	303,170	279,759
Mortgage commissions	38,143	23,410	127,160	94,859
Other income	338,154	174,557	717,763	561,250
Total non-interest income	777,636	634,472	2,023,322	1,920,424
Salaries and employee benefits	1,974,022	2,319,467	5,889,247	7,200,869
Occupancy expenses	658,928	675,728	2,031,844	2,015,674
Data processing fees	220,181	193,009	672,597	562,007
OREO expenses	915,623	485,292	1,974,375	936,370
Assessments (FDIC & DFI)	230,269	87,160	667,355	259,056
Other operating expenses	745,563	774,553	2,234,073	2,179,393
Total non-interest expense	4,744,586	4,535,209	13,469,491	13,153,369
Net income before provision (benefit) for income taxes	1,127,852	788,991	1,154,997	2,761,080
Provision (benefit) for income taxes	248,701	239,595	(109,401)	883,150
Net income	$ 879,151	$ 549,396	$ 1,264,398	$ 1,877,930
Preferred stock dividends and accretion	210,411	0	631,233	0
Net income available to common shareholders	$ 668,740	$ 549,396	$ 633,165	$ 1,877,930
Net income per common share	$ 0.09	$ 0.07	$ 0.08	$ 0.25

Net income per common diluted share	$	0.09	$	0.07	$	0.08	$	0.24

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)

FOR THE YEAR ENDED DECEMBER 31, 2008 AND THE NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2009

YEAR ENDED DECEMBER 31, 2008 AND THE NINE MONTH PERIOD ENDED SEPTEMBER 30, 2009

	Common Stock Shares	Common Stock Amount	Preferred Stock	Additional Paid-in Capital	Retained Earnings	Comprehensive Income	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balances, January 1, 2008	7,607,780	$ 22,843,171		$ 1,748,380	$ 17,723,646		$ 46,193	$ 42,361,390
Stock options exercised	53,847	186,922						186,922
Issuance of preferred stock			$ 12,666,762					12,666,762
Issuance of TCPP warrants		833,238						833,238
Preferred stock accretion			13,887		(13,887)			0
Tax benefit of stock options exercised				54,195				54,195
Cash dividends ($0.075 per share)					(574,484)			(574,484)
Stock based compensation				122,649				122,649
Cumulative effect of adopting EITF 06-04					(70,459)			(70,459)
Comprehensive income								
Net changes in unrealized gain on available-for-sale securities (net of income tax of $158,664)						244,037	244,037	244,037
Net income					2,161,829	2,161,829		2,161,829
Comprehensive income						$ 2,405,866		
Balances, December 31, 2008	7,661,627	$ 23,863,331	$ 12,680,649	$ 1,925,224	$ 19,226,645		$ 290,230	$ 57,986,079
Stock options exercised	20,250	$ 70,110						70,110
Preferred stock accretion			$ 124,986		$ (124,986)			0
Preferred stock dividend payments					(468,750)			(468,750)
Cash dividends ($0.025 per share)					(191,541)			(191,541)
Stock based compensation				$ 56,400				56,400
Comprehensive income								

Net changes in unrealized gain on available-for-sale securities (net of income tax of $955,957)						1,346,761	1,346,761	1,346,761
Net income					1,264,398	1,264,398		1,264,398
Comprehensive income						$ 2,611,159		
Balances, September 30, 2009	7,681,877	$ 23,933,441	$ 12,805,635	$ 1,981,624	$ 19,705,766		$ 1,636,991	$ 60,063,457

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2009 AND SEPTEMBER 30, 2008

	NINE MONTHS ENDED SEPTEMBER 30, 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,264,398	$ 1,877,930
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision for loan losses	4,962,012	1,187,000
Depreciation, amortization and accretion, net	775,748	835,826
Stock-based compensation expense	56,400	101,498
Excess tax benefits from stock-based payment arrangements	0	(54,195)
Gain on sale of premises and equipment	0	(2,428)
OREO Write downs and losses on sale	1,974,375	936,370
Gain on called available for sale securities	(132,192)	0
Decrease in accrued interest payable and other liabilities	(385,587)	(939,301)
Decrease in accrued interest receivable	113,663	100,599
Increase in other assets	(1,848,463)	(2,835,696)
Net cash from operating activities	6,780,354	1,207,603
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(16,925,358)	(6,459,330)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	7,275,261	6,995,919
Net increase in loans	(2,697,451)	(34,320,111)
Purchase of BOLI policies	0	(4,740,000)
Proceeds from sale of OREO	209,467	0
Proceeds from sales of premises and equipment	0	47,778
Net purchases of premises and equipment	(82,872)	(1,025,346)
Net cash used in investing activities	(12,220,953)	(39,501,090)
CASH FLOWS FROM FINANCING ACTIVITIES:		
FHLB advanced funds	50,700,000	205,463,000
FHLB payments	(92,700,000)	(158,463,000)
Federal funds advances	8,770,000	63,175,000
Federal funds payments	(8,770,000)	(63,175,000)
Shareholder cash dividends paid	(191,541)	(382,943)
Preferred stock dividend payment	(468,750)	0
Net increase in demand deposits and savings accounts	48,137,511	6,249,207
Net increase (decrease) in time deposits	5,146,855	(18,367,424)
Excess tax benefits from stock-based payment arrangements	0	54,195
Proceeds from sale of common stock and exercise of stock options	70,110	176,047
Net cash from financing activities	10,694,185	34,729,082
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	5,253,586	(3,564,405)
CASH AND CASH EQUIVALENTS, beginning of period	9,837,860	14,202,951
CASH AND CASH EQUIVALENTS, end of period	$ 15,091,446	$ 10,638,546

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:				
Cash paid during the year for:				
Interest	$	4,766,247	$	7,860,601
Income taxes	$	1,014,000	$	890,000
NON-CASH INVESTING ACTIVITIES:				
Real estate acquired through foreclosure	$	1,186,263	$	4,364,693
Change in unrealized gain/loss on available-for-sale securities	$	2,302,718	$	55,724
NON-CASH FINANCING ACTIVITIES:				
Tax benefit from stock options exercised	$	0	$	54,195
Cumulative effect of adopting EITF 06-04	$	0	$	119,842
Accretion of preferred stock	$	124,986	$	0

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

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OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

On July 3, 2008 (the Effective Date), a bank holding company reorganization was completed whereby Oak Valley Bancorp became the parent holding company for Oak Valley Community Bank (the Bank). On the Effective Date, each outstanding share of the Bank was converted into one share of Oak Valley Bancorp and the Bank became a wholly-owned subsidiary of the holding company. The condensed consolidated financial statements and accompanying footnotes are presented as if the reorganization occurred as of the earliest periods presented and are consistent with those of Oak Valley Community Bank, since prior to the Effective Date, Oak Valley Bancorp had no material assets, liabilities or operations.

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

Management has evaluated subsequent events for potential recognition and/or disclosure through the issuance date of this Form 10-Q, and has determined that there were no subsequent events that require recognition or disclosure.

The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three and nine month periods ended September 30, 2009 are not necessarily indicative of the results of a full year s operations. For further information, refer to the audited financial statements and footnotes included in the Company s Form 10-K for the year ended December 31, 2008.

NOTE 2 CURRENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Codification. The Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) became effective on July 1, 2009. At that date, the ASC became FASB s officially recognized source of authoritative U.S. generally accepted accounting principles (GAAP) applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the away companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

FASB ASC Topic 815, Derivatives and Hedging. New authoritative accounting guidance under ASC Topic 815, Derivatives and Hedging, amends prior guidance to amend and expand the disclosure requirements for derivatives and hedging activities to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under ASC Topic 815, and (iii) how derivative instruments and related hedged items affect an entity s financial position, results of operations and cash flows. To meet those objectives, the new authoritative accounting guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. The new authoritative accounting guidance under ASC Topic 815 became effective for the Company on January 1, 2009 and did not have a significant impact on the Company s financial statements.

FASB ASC Topic 820, Fair Value Measurements and Disclosures. New authoritative accounting guidance under ASC Topic 820, Fair Value Measurements and Disclosures, affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The Company adopted the new authoritative accounting guidance under ASC Topic 820 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Company s financial statements.

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Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The forgoing new authoritative accounting guidance under ASC Topic 820 will be effective for the Company s financial statements beginning October 1, 2009 and is not expected to have a significant impact on the Company s financial statements.

FASB ASC Topic 320, Investments - Debt and Equity Securities. New authoritative accounting guidance under ASC Topic 320, Investments - Debt and Equity Securities, (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Company adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 during the second quarter of 2009. Adoption of the new guidance did not significantly impact the Company s financial statements.

FASB ASC Topic 825 Financial Instruments. New authoritative accounting guidance under ASC Topic 825, Financial Instruments, requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods. The new interim disclosures required under Topic 825 are included in Note7 Financial Instruments.

FASB ASC Topic 855, Subsequent Events. New authoritative accounting guidance under ASC Topic 855, Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity s management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 became effective for the Company s financial statements for periods ending after June 15, 2009 and did not have a significant impact on the Company s financial statements.

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NOTE 3 SECURITIES

The amortized cost and estimated fair values of debt securities as of September 30, 2009 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
U.S. agencies	$ 31,519,509	$ 1,494,746	$	$ 33,014,255
Collateralized mortgage obligations	3,058,158	110,576		3,168,734
Municipalities	12,963,637	1,191,704		14,155,341
SBA Pools	1,600,014		(46,451)	1,553,563
Asset-Back Security	114,636	1,843		116,479
Mutual Fund	1,526,602	29,688		1,556,290
	$ 50,782,556	$ 2,828,557	$ (46,451)	$ 53,564,662

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009.

	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. agencies	$	$	$		$	$
Collateralized mortgage obligations						
Municipalities						
SBA Pools			1,547,982	(46,451)	1,547,982	(46,451)
Asset Backed Securities						
Total temporarily impaired securities	$	$	$ 1,547,982	$ (46,451)	$ 1,547,982	$ (46,451)

At September 30, 2009, a total of two SBA pools make up the total amount of securities in an unrealized loss position for greater than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes and the Bank has the ability and intent to hold all investment securities with identified impairments resulting from interest rate changes to the earlier of the forecasted recovery or the maturity of the underlying investment security and it is unlikely that the Bank will be required to sell the securities before recovery of their amortized cost.

The amortized cost and estimated fair value of debt securities at September 30, 2009, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Available-for-sale securities:		
3 Months or Less	$ 510,000	$ 510,223
Due after one year through five years	1,976,801	2,009,439
Due after five years through ten years	13,008,973	13,729,015
Due after ten years	35,286,782	37,315,985
	$ 50,782,556	$ 53,564,662

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The amortized cost and estimated fair values of debt securities as of December 31, 2008, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
U.S. agencies	$ 25,540,641	$ 609,957	$ (65,680)	$ 26,084,918
Collateralized mortgage obligations	3,438,998	54,471	(8,861)	3,484,608
Municipalities	9,970,961	14,829	(83,567)	9,902,223
SBA Pools	1,820,810		(41,682)	1,779,128
Asset-Back Security	198,081		(81)	198,000
	$ 40,969,491	$ 679,257	$ (199,871)	$ 41,448,877

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2008.

	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. agencies	$ 2,900,405	$ (13,962)	$ 3,067,267	$ (51,718)	$ 5,967,672	$ (65,680)
Collateralized mortgage obligations	618,552	(2,109)	1,085,704	(6,752)	1,704,256	(8,861)
Municipalities	9,357,996	(83,567)			9,357,996	(83,567)
SBA Pools			1,626,502	(41,682)	1,626,502	(41,682)
Asset Backed Securities	198,000	(81)			198,000	(81)
Total temporarily impaired securities	$ 13,074,953	$ (99,719)	$ 5,779,473	$ (100,152)	$ 18,854,426	$ (199,871)

At December 31, 2008, a total of four U.S. agencies, one collateralized mortgage obligations and two SBA pools make up the total amount of securities in an unrealized loss position for greater than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes and the Bank has the ability and intent to hold all investment securities with identified impairments resulting from interest rate changes to the earlier of the forecasted recovery or the maturity of the underlying investment security and it is unlikely that the Bank will be required to sell the securities before recovery of their amortized cost.

There were no realized gains or losses on sales of available-for-sale securities during 2009 and 2008, however the Company did recognize a gain of $132,192 for the nine months ended September 30, 2009 on certain available-for-sale securities that were partially called. There were no other sales of available-for-sale securities during 2009 and 2008.

Securities carried at $40,699,006 and $30,117,814 at September 30, 2009 and December 31, 2008, respectively, were pledged to secure deposits of public funds.

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OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 LOANS

Loan totals were as follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Loans		
Commercial real estate	$ 281,214,733	$ 268,741,826
Commercial	38,776,179	37,302,286
Real estate construction	55,926,032	73,321,446
Agriculture	27,395,078	25,916,928
Residential real estate and consumer	22,061,847	22,894,644
Total loans	425,373,869	428,177,130
Less:		
Deferred loan fees and costs, net	(855,415)	(1,034,723)
Allowance for loan losses	(6,396,367)	(5,569,496)
Net loans	$ 418,122,087	$ 421,572,911

Changes in the allowance for loan losses were as follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Balance, beginning of year	$ 5,569,496	$ 4,506,753
Provision charged to operations	4,962,012	2,188,139
Loans charged off	(4,138,994)	(1,114,534)
Loan recoveries	3,853	4,746
Reclassification of reserve related to off-balance-sheet commitments		(15,608)
Balance, end of period	$ 6,396,367	$ 5,569,496

Effective July 1, 2008, the expense associated with the allowance for off-balance-sheet commitments is recorded separately as a component of other expenses. In 2008, the $15,608 reclassification from the allowance for loan losses to other liabilities is a non-recurring adjustment.

The total recorded investment in impaired loans at September 30, 2009, was $8,913,581 which had a loan loss reserve of $690,252. The total recorded investment in impaired loans at December 31, 2008, was $4,078,765 which had a loan loss reserve of $768,719. No interest income was recognized on impaired loans, while considered impaired during 2009 and 2008. As of September 30, 2009, we had undisbursed funding commitments on **three** impaired loans to **one** borrower totaling $1,107,409 with maturity dates of **April 2010, May 2010 and October 2010.**

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 OTHER REAL ESTATE OWNED

As of September 30, 2009, seven loans with outstanding balances of $1,990,782 were reclassified to other real estate owned.

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

NOTE 6 – OTHER POST-RETIREMENT BENEFIT PLANS

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

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

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

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

The combined cash surrender value of all Bank-owned life insurance policies recorded in other assets on the balance sheet was $10,361,219 and $9,859,234 at September 30, 2009 and December 31, 2008, respectively.

NOTE 7 FINANCIAL INSTRUMENTS

Fair values of financial instruments The financial statements include various estimated fair value information as of September 30, 2009 and December 31, 2008. Such information, which pertains to the Bank s financial instruments, does not purport to represent the aggregate net fair value of the Bank. 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. The following methods and assumptions are used by the Bank.

Cash and cash equivalents The carrying amounts of cash and cash equivalents approximate their fair value.

Securities (including mortgage-backed securities) Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Loans receivable For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are

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estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Deposit liabilities The fair values estimated for demand deposits (interest and non-interest checking, passbook 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.

Federal Home Loan Bank (FHLB) advances Rates currently available to the Bank for borrowings with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

Accrued interest The carrying amounts of accrued interest approximate their fair value.

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 estimated fair values of the Bank s financial instruments at September 30, 2009 are as follows:

	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and cash equivalents	$ 15,091,446	$ 15,091,446
Securities available for sale	53,564,662	53,564,662
Loans	425,373,869	435,832,855
Accrued interest receivable	1,772,696	1,772,696
Financial liabilities:		
Deposits	(431,532,833)	(429,414,632)
FHLB advance	(27,000,000)	(27,247,807)
Accrued interest payable	(456,072)	(456,072)
Off-balance-sheet assets (liabilities):		
Commitments and standby letters of credit		(642,114)

The estimated fair values of the Bank s financial instruments at December 31, 2008 are as follows:

	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and cash equivalents	$ 9,837,860	$ 9,837,860
Securities available for sale	41,448,877	41,448,877
Loans	428,177,130	429,344,847
Accrued interest receivable	1,886,359	1,886,359
Financial liabilities:		
Deposits	(378,248,467)	(378,041,128)
FHLB advance	(69,000,000)	(69,103,323)
Accrued interest payable	(763,117)	(763,117)
Off-balance-sheet assets (liabilities):		
Commitments and standby letters of credit		(630,751)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 FAIR VALUE MEASUREMENTS

Fair Value Measurements, which the Company adopted effective January 1, 2008, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

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

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

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

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment , and considers factors specific to the asset or liability.

Assets and liabilities measured at fair value on a recurring and non-recurring basis are summarized below:

		Fair Value Measurements at September 30, 2009 Using		
	September 30, 2009	**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	$ 53,564,662	$	$ 53,564,662	$
Assets and liabilities measured on a non-recurring basis:				
Impaired Loans	$ 8,223,329	$	$	$ 8,223,329
Other real estate owned	$ 1,990,782	$	$	$ 1,990,782

The fair value of securities available for sale equals quoted market price, if available. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities. Changes in fair market value are recorded in other comprehensive income net of tax.

The fair value measurement applies to impaired loans, which includes impaired loans measured at an observable market price (if available), or at the fair value of the loan s collateral (if the loan is collateral dependent). Fair value of the loan s collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral. At September 30, 2009, impaired loans had a principal balance of $8,913,581, with a valuation allowance of $690,252. Upon being classified as impaired, charge offs were taken to reduce the balance of each loan to an estimate of the collateral fair market value less cost to dispose. This estimate was a level 3 valuation. There was no direct impact on the income statement. The charge-offs were recorded as a debit to the allowance for loan losses.

Fair value of other real estate owned is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the property. Total fair market value at September 30, 2009 was $1,990,782 which was a level 3 valuation. There is a direct impact to the income statement as any market value write downs are charged directly to operating expenses. The Bank is required by internal bank policies to order real estate appraisals on OREO properties every six months. In addition, management evaluates the book values on a quarterly basis for reasonableness and makes fair value adjustments as necessary.

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OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9 EARNINGS (LOSS) PER SHARE

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

In thousands (except share and per share amounts)	THREE MONTHS ENDED SEPTEMBER 30, 2009		2008	
BASIC EARNINGS PER SHARE				
Net income available to common shareholders	$	668,740	$	549,396
Weighted average shares outstanding		7,668,891		7,658,252
Net income per common share	$	0.09	$	0.07
DILUTED EARNINGS PER SHARE				
Net income available to common shareholders	$	668,740	$	549,396
Weighted average shares outstanding		7,668,891		7,658,252
Effect of dilutive stock options		25,167		84,839
Weighted average shares of common stock and common stock equivalents		7,694,058		7,743,091
Net income per diluted common share	$	0.09	$	0.07

In thousands (except share and per share amounts)	NINE MONTHS ENDED SEPTEMBER 30, 2009		2008	
BASIC EARNINGS PER SHARE				
Net income available to common shareholders	$	633,165	$	1,877,930
Weighted average shares outstanding		7,664,075		7,636,687
Net income per common share	$	0.08	$	0.25
DILUTED EARNINGS PER SHARE				
Net income available to common shareholders	$	633,165	$	1,877,930
Weighted average shares outstanding		7,664,075		7,636,687
Effect of dilutive stock options		28,035		100,363
Weighted average shares of common stock and common stock equivalents		7,692,110		7,737,050
Net income per diluted common share	$	0.08	$	0.24

During the three and nine month periods ended September 30, 2009, anti-dilutive weighted average options to purchase 240,187 and 241,888 shares of common stock, respectively, with prices ranging from $4.58 to $15.67 were outstanding. Anti-dilutive weighted average options of

260,304 and 244,728 were outstanding during the same three and nine month periods of 2008, respectively, with prices ranging from $7.00 to $15.67. These options were not included in the computation of diluted EPS because the options exercise price was greater than the average market price of the common shares. These options begin to expire in 2013.

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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 2008 Annual Report.

Forward-Looking Statements

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

Critical Accounting Estimates

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.

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 in accordance with SFAS No. 5, Accounting for Contingencies, and
- our judgmental estimate based on various subjective factors.

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

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

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

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- 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.

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

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

Non-Accrual Loan Policy

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on nonaccrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals.

Stock-Based Compensation

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

Other Real Estate Owned

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

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The fair value of the property is based upon a current appraisal. The difference between the fair value of the real estate collateral and the loan balance at the time of transfer is recorded as a loan charge off if fair value is lower. Subsequent to foreclosure, management periodically performs valuations and the OREO property is carried at the lower of carrying value or fair value, less costs to sell. The determination of a property s estimated fair value incorporates (1) revenues projected to be realized from disposal of the property, (2) construction and renovation costs, (3) marketing and transaction costs, and (4) holding costs (e.g., property taxes, insurance and homeowners association dues). Any subsequent declines in the fair value of the OREO property after the date of transfer are recorded through a write-down of the asset. Any subsequent operating expenses or income, reduction in estimated fair values, and gains or losses on disposition of such properties are charged or credited to current operations.

Introduction

Oak Valley Community Bank commenced operations in May 1991. We are an insured bank under the Federal Deposit Insurance Act and are a member of the Federal Reserve. Since its formation, the Bank has provided basic banking services to individuals and business enterprises in Oakdale, California and the surrounding areas. The focus of the Bank is to offer a range of commercial banking services designed for both individuals and small to medium-sized businesses in the two main areas of service of the Bank: 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. The Bank introduced a mortgage-lending program, Community Bank Lending Exchange (CBLX), at the beginning of 2003. At September 30, 2009, the Bank has originated $227 million in loans for funding by CBLX.

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

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

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 shareholders value strategy has three major themes: (1) enhancing shareholders 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 quarter and nine month period ended September 30, 2009:

- Thanks to our deep roots in the communities that we serve, our focus on customer care and our selectivity in lending, during the first nine months of 2009, our performance has been better than most institutions of our size that compete in our market. Despite the severity of the recession affecting our primary market areas, we have been able to increase our core deposits to $377.4 million and have posted a year-to-date net income per common share of $0.08.

- While recently published economic data indicate that the current downturn may be easing, it is not clear when or at what speed the recession will end. To the extent that the recession continues, it will affect the market areas that we serve and our results accordingly.

- The Company recognized net income available to common shareholders of $668,740 and $633,165 for the three and nine month periods ended September 30, 2009 as compared with net income available to common shareholders of $549,396 and $1,877,930 for the same periods in 2008. The Company recognized net income before preferred stock dividends and accretion of $879,151 and $1,264,398 for the third quarter and nine month period of 2009. The factors contributing to these results will be discussed below.

- The Company recognized $210,411 and $631,233 in the third quarter and nine month period of 2009 associated with the accrual for preferred stock dividends and accretion of the preferred stock discount in connection with the 13,500 shares of

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Series A Preferred Stock that the U.S. Treasury purchased from the Company in December 2008 under the TARP Program. So long as such preferred stock remains outstanding, it will pay quarterly cumulative dividends at a rate of 5% per year for the first five years and thereafter at a rate of 9% per year. There was no accrual or accretion recognized in the third quarter and first nine month period of 2008, as the Series A Preferred Stock was issued in December 2008.

- The Company has taken significant steps to reduce the risk of loan losses. In the three and nine month period ended September 30, 2009, the provision for loan losses increased by $323,000 and $3,775,012, respectively, compared to the same periods in 2008. These increases were mainly due to management s assessment of the appropriate level for the allowance for loan losses, an increase in the level of non-accrual loans and overall growth in gross loans. The Company continues to monitor its loan portfolio with the objective of avoiding defaults or write-downs. Despite these actions, the possibility of additional losses can not be eliminated, but the Board of Directors and all employees continue to work hard to make the best of these continuing challenging conditions.

- Net interest income increased $728,074 or 13.8% and $2,382,153 or 15.7% for the three and nine month periods ended September 30, 2009, respectively, compared to the same periods in 2008. This increase was primarily due to the net interest margin increase of 30 and 25 basis points and increases in average earning assets of $38.1 million and $50.3 million for the three and nine month periods ended September 30, 2009, respectively, as compared to the same periods of 2008. The net interest margin increase is attributable primarily to liabilities repricing faster than assets in the declining rate environment as described in further detail below.

- For the three and nine month periods ended September 30, 2009, non-interest income increased by $143,164 or 22.6% and $102,898 or 5.4% from the same periods in 2008, respectively. The increase was primarily due to an increase in investment service fee income and the gain on called securities, which was partially offset by a decrease in NSF fee income as described below.

- Non-interest expense increased by $209,377 or 4.6% and $316,122 or 2.4% for the three and nine month periods ended September 30, 2009, respectively, as compared to the same periods in 2008, primarily due to write downs of OREO property values which was offset by decreases in salaries and benefits as described below.

- Total assets increased $13.0 million or 2.6% from December 31, 2008. Total net loans decreased by $3.5 million or 0.8% and investment securities increased by $12.1 million or 29.2% from December 31, 2008 to September 30, 2009, while deposits increased by $53.3 million or 14.1%.

Income Summary

For the three and nine month periods ended September 30, 2009, the Company recorded net income available to common shareholders of $668,740 and $633,165, an increase of $119,344 for the quarter and a decrease of $1,244,765 for the nine month period of 2009, as compared to the $549,396 and $1,877,930 for the same periods in 2008. Return on average assets (annualized) was 0.67% and 0.32% for the third quarter and nine month period of 2009, respectively, as compared with 0.45% and 0.53% for the same periods in 2008. Annualized return on average common equity was 5.73% and 1.85% for the third quarter and nine month period of 2009, respectively, as compared with 4.91% and 5.71% for the same periods of 2008.

Net income before provisions for income taxes and preferred stock dividends and accretion was up $338,861 for the third quarter and down $1,606,083 for the nine month period of 2009 from the comparable 2008 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	Effect on Pre-Tax Income Increase (Decrease) Nine Months
Change from 2008 to 2009 in:		
Net interest income	$ 728,074	$ 2,382,153
Provision for loan losses	(323,000)	(3,775,012)
Non-interest income	143,164	102,898
Non-interest expense	(209,377)	(316,122)
Change in income before income taxes	$ 338,861	$ (1,606,083)

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These variances will be explained in the discussion below.

Net Interest Income

Net interest income is the largest source of the Bank s operating income. For the three and nine month periods ended September 30, 2009, net interest income was $6.02 million and $17.56 million, respectively, which represented an increase of $728,074 or 13.8% and $2,382,153 or 15.7%, respectively, from the comparable periods in 2008.

The net interest margin (net interest income as a percentage of average interest earning assets) was 5.06% and 4.96% for the three and nine month periods ended September 30, 2009, an increase of 30 and 25 basis points as compared to the same periods in 2008. The increase in the net interest margin in 2009 was primarily attributable to the impact that the decline in market interest rates had on our liability sensitive balance sheet which caused interest-bearing liabilities to decrease faster than the yields on earning assets. The compression of the yield on interest earning assets was lessened due to a portion of our loan portfolio that was at the contractual rate floors. In addition, yield on investments increased by 102 and 108 basis points for the three and nine month periods ended September 30, 2009, respectively, as a result of approximately $12.5 million in municipal securities purchased in the fourth quarter of 2008 and first quarter 2009 and the related fully taxable equivalent benefit.

The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2009 and 2008:

Net Interest Analysis

(Dollars in thousands)

	Three Months Ended September 30, 2009			Three Months Ended September 30, 2008		
	Average Balance	**Interest Inc / Exp**	**Avg Rate/ Yield**	**Average Balance**	**Interest Inc / Exp**	**Avg Rate/ Yield**
Assets:						
Earning assets:						
Gross loans (1) (2)	$ 423,947	$ 6,751	6.32%	$ 408,476	$ 7,047	6.84%
Investment securities (2)	51,811	777	5.95%	33,475	416	4.93%
Federal funds sold	2,095	1	0.25%	877	4	1.93%
Interest-earning deposits	3,347	2	0.23%	242	1	0.93%
Total interest-earning assets	481,200	7,531	6.21%	443,070	7,468	6.69%
Total noninterest earning assets	40,084			39,090		
Total Assets	521,284			482,160		
Liabilities and Shareholders Equity:						
Interest-bearing liabilities:						
Money market deposits	191,740	630	1.30%	153,260	927	2.40%

NOW deposits	58,643	70	0.47%	54,711	102	0.74%
Savings deposits	13,362	20	0.58%	15,225	47	1.23%
Time certificates of deposit $100,000 or more	47,678	264	2.19%	33,177	280	3.34%
Other time deposits	52,821	263	1.97%	43,696	346	3.14%
Other borrowings	31,752	153	1.91%	73,900	456	2.45%
Total interest-bearing liabilities	395,996	1,400	1.40%	373,969	2,158	2.29%
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	62,498			60,846		
Other liabilities	3,020			2,999		
Total noninterest-bearing liabilities	65,518			63,845		
Shareholders equity	59,770			44,346		
Total liabilities and shareholders equity	$ 521,284			$ 482,160		
Net interest income		$ 6,131			$ 5,310	
Net interest spread (3)			4.81%			4.40%
Net interest margin (4)			5.06%			4.76%

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

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

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

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

	Nine months ended September 30, 2009			**Nine months ended September 30, 2008**		
	Average Balance	**Interest Income / Expense**	**Avg Rate/ Yield**	**Average Balance**	**Interest Income / Expense**	**Avg Rate/ Yield**
Assets:						
Earning assets:						
Gross loans (1) (2)	$ 427,513	$ 20,081	6.28%	$ 396,583	$ 20,771	6.98%
Investment securities (2)	50,422	2,249	5.96%	33,964	1,244	4.88%
Federal funds sold	1,661	3	0.24%	780	14	2.36%
Interest-earning deposits	2,201	4	0.22%	146	2	1.45%
Total interest-earning assets	481,797	22,337	6.20%	431,473	22,031	6.80%
Total noninterest earning assets	38,626			36,287		
Total Assets	520,423			467,760		
Liabilities and Shareholders Equity:						
Interest-bearing liabilities:						
Money market deposits	176,878	1,910	1.44%	145,810	2,748	2.51%
NOW deposits	56,654	215	0.51%	54,994	298	0.72%
Savings deposits	14,003	86	0.83%	16,313	227	1.85%
Time certificates of deposit $100,000 or more	46,598	850	2.44%	39,418	1,166	3.94%
Other time deposits	53,081	858	2.16%	42,209	1,130	3.57%
Other borrowings	49,123	540	1.47%	60,551	1,222	2.69%
Total interest-bearing liabilities	396,337	4,459	1.50%	359,295	6,791	2.52%
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	61,776			61,556		
Other liabilities	2,954			3,127		
Total noninterest-bearing liabilities	64,730			64,683		
Shareholders equity	59,356			43,782		
Total liabilities and shareholders equity	$ 520,423			$ 467,760		
Net interest income		$ 17,878			$ 15,240	
Net interest spread (3)			4.69%			4.28%
Net interest margin (4)			4.96%			4.71%

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

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

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

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

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Shown in the following tables are the relative impacts on net interest income of changes in the average outstanding balances (volume) of earning assets and interest bearing liabilities and the rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2009 and 2008. Changes in interest income and expense that are not attributable specifically to either rate or volume are allocated to the rate column below.

Rate / Volume Variance Analysis

(In thousands)

	For the Three Months Ended September 30, 2009 vs 2008 Increase (Decrease) in interest income and expense due to changes in:		
	Volume	**Rate**	**Total**
Interest income:			
Gross loans (1)	$ 267	$ (563)	$ (296)
Investment securities	228	134	362
Federal funds sold	6	(9)	(3)
Interest-earning deposits	7	(6)	1
Total interest income	**$ 508**	**$ (444)**	**$ 64**
Interest expense:			
Money market deposits	233	(529)	(296)
NOW deposits	7	(40)	(33)
Savings deposits	(6)	(22)	(28)
Time CD $100K or more	122	(138)	(16)
Other time deposits	72	(155)	(83)
Other borrowings	(260)	(41)	(301)
Total interest expense	**$ 169**	**$ (925)**	**$ (757)**
Change in net interest income	**$ 340**	**$ 481**	**$ 821**

	For the Nine Months Ended September 30, 2009 vs 2008 Increase (Decrease) in interest income and expense due to changes in:		
	Volume	**Rate**	**Total**
Interest income:			
Gross loans (1)	$ 1,620	$ (2,310)	$ (690)
Investment securities	603	402	1,005
Federal funds sold	16	(27)	(11)
Interest-earning deposits	22	(20)	2
Total interest income	**$ 2,261**	**$ (1,955)**	**$ 306**
Interest expense:			
Money market deposits	585	(1,423)	(838)
NOW deposits	9	(93)	(84)
Savings deposits	(32)	(108)	(140)
Time CD $100K or more	212	(529)	(317)

Other time deposits		291		(563)		(272)
Other borrowings		(231)		(449)		(680)
Total interest expense	$	**834**	$	**(3,165)**	$	**(2,331)**
Change in net interest income	$	**1,427**	$	**1,210**	$	**2,637**

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

The table above reflects the market interest rate decline has impacted liabilities slightly more than assets as indicated by the increase of $1,210,000 in net interest income due to the rate change for the nine month period of 2009. The increased loan volume and the overall change in mix of deposit balances contributed an increase of $1,427,000 to net interest income.

Non-Interest Income

Non-interest income represents service charges on deposit accounts and other non-interest related charges and fees, including fees from the sale of loans and investment service fee income. For the three and nine month periods ended September 30, 2009, non-interest income was $777,636 and $2,023,322, an increase of $143,164 or 22.6% and $102,898 or 5.4%, respectively, compared to the same periods in 2008.

The following table shows the major components of non-interest income:

For the Three Months Ended September 30,			For the Nine Months Ended September 30,
2009	**2008**	**$ change**	