SIERRA BANCORP
Form 10-Q
November 09, 2011

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

Commission file number: 000-33063

SIERRA BANCORP
(Exact name of Registrant as specified in its charter)

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

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

(559) 782-4900
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes R No ¨

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

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

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

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

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

Common stock, no par value, 14,101,259 shares outstanding as of October 31, 2011

FORM 10-Q

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PART I - FINANCIAL INFORMATION
Item 1
SIERRA BANCORP
CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	September 30, 2011 (unaudited)	December 31, 2010 (audited)
ASSETS		
Cash and due from banks	$ 40,612	$ 42,110
Interest-bearing deposits in other banks	17,693	325
Federal funds sold	-	210
Total Cash & Cash Equivalents	58,305	42,645
Investment securities available for sale	429,828	331,730
Loans and leases:		
Loans held for sale	855	914
Gross loans and leases	757,784	804,626
Allowance for loan and lease losses	(20,492)	(21,138)
Deferred loan and lease fees, net	403	113
Net Loans and Leases	738,550	784,515
Premises and equipment, net	19,455	20,190
Operating leases, net	507	904
Foreclosed assets	18,185	20,691
Goodwill	5,544	5,544
Other assets	80,868	80,352
TOTAL ASSETS	$ 1,351,242	$ 1,286,571
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Non-interest bearing	$ 286,474	$ 251,908
Interest bearing	807,145	800,366
Total Deposits	1,093,619	1,052,274
Federal funds purchased and repurchase agreements	4,633	-
Short-term borrowings	25,000	14,650
Long-term borrowings	15,000	15,000
Other liabilities	13,737	14,122
Junior subordinated debentures	30,928	30,928
TOTAL LIABILITIES	1,182,917	1,126,974
SHAREHOLDERS' EQUITY		
Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued	-	-
Common stock, no par value; 24,000,000 shares authorized; 14,062,259 and 13,976,741 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	56,624	63,477

Additional paid in capital		9,316		1,652
Retained earnings		97,288		93,570
Accumulated other comprehensive income		5,097		898
TOTAL SHAREHOLDERS' EQUITY		168,325		159,597
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$	1,351,242	$	1,286,571

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

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SIERRA BANCORP
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data, unaudited)

	For the Quarter Ended September 30, 2011	For the Quarter Ended September 30, 2010	For the Nine Months Ended September 30, 2011	For the Nine Months Ended September 30, 2010
Interest income:				
Interest and fees on loans	$11,780	$13,074	$35,480	$40,147
Interest on investment securities:				
Taxable	2,420	2,131	6,621	6,282
Tax-exempt	716	695	2,153	2,012
Interest on federal funds sold and interest-bearing Deposits	23	8	56	30
Total interest income	14,939	15,908	44,310	48,471
Interest expense:				
Interest on deposits	1,063	1,496	3,279	4,825
Interest on short-term borrowings	7	49	46	141
Interest on long-term borrowings	143	143	425	461
Interest on manditorily redeemable trust preferred securities	179	198	540	553
Total interest expense	1,392	1,886	4,290	5,980
Net Interest Income	13,547	14,022	40,020	42,491
Provision for loan losses	3,000	6,380	9,600	13,280
Net Interest Income after Provision for Loan Losses	10,547	7,642	30,420	29,211
Non-interest revenue:				
Service charges on deposit accounts	2,439	2,959	7,140	8,549
Gains on investment securities available-for-sale	-	2,639	-	2,639
Other	930	1,455	3,278	3,715
Total other operating income	3,369	7,053	10,418	14,903
Other operating expense:				
Salaries and employee benefits	4,849	4,582	15,760	15,511
Occupancy expense	1,787	1,774	4,987	5,332
Other	3,932	8,239	13,078	17,473
Total other operating expenses	10,568	14,595	33,825	38,316
Income before income taxes	3,348	100	7,013	5,798
Provision for income taxes	822	(787)	774	27
Net Income	$2,526	$887	$6,239	$5,771
PER SHARE DATA				

Book value	$11.97	$11.88	$11.97	$11.88
Cash dividends	$0.06	$0.06	$0.18	$0.18
Earnings per share basic	$0.18	$0.08	$0.45	$0.50
Earnings per share diluted	$0.18	$0.08	$0.44	$0.49
Average shares outstanding, basic	14,051,614	11,650,137	14,015,583	11,642,517
Average shares outstanding, diluted	14,097,368	11,738,067	14,081,936	11,728,261

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

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

	Nine Months Ended September 30, 2011	2010
Cash flows from operating activities:		
Net income	$ 6,239	$ 5,771
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on investment of securities	-	(2,639)
Gain on sales of loans	(93)	(60)
Gain on disposal of fixed assets	(12)	(108)
Loss on sale on foreclosed assets	569	446
Writedown on foreclosed assets	1,656	4,473
Share-based compensation expense	166	98
Provision for loan losses	9,600	13,280
Depreciation and amortization	1,971	2,237
Net amortization on securities premiums and discounts	4,031	2,249
Increase in unearned net loan fees	(291)	(590)
Increase in cash surrender value of life insurance policies	(5,538)	(1,022)
Proceeds from sales of loans portfolio	3,440	1,225
Net Decrease in loans held-for-sale	59	56
Decrease (Increase) in interest receivable and other assets	1,362	(1,146)
Decrease in other liabilities	(389)	(851)
Net Decrease in Restricted Stock, at Cost	996	667
Deferred income tax benefit	(105)	(143)
Excess tax provision (benefit) from equity based compensation	4	(15)
Net cash provided by operating activities	23,665	23,928
Cash flows from investing activities:		
Maturities of securities available for sale	2,664	6,251
Proceeds from sales/calls of securities available for sale	3,119	74,183
Purchases of securities available for sale	(154,229)	(169,921)
Principal paydowns on securities available for sale	53,430	49,951
Decrease in loans receivable, net	28,709	29,262
Purchases of premises and equipment, net	(830)	(1,767)
Proceeds from sales of foreclosed assets	4,681	4,520
Net cash used in investing activities	(62,456)	(7,521)
Cash flows from financing activities:		
Increase (Decrease) in deposits	41,345	(35,877)
Increase (Decrease) in borrowed funds	10,350	(2,740)
Increase in repurchase agreements	4,633	-
Cash dividends paid	(2,522)	(2,097)
Payments of stock issuance costs	(23)	-
Stock options exercised	672	229
Excess tax (benefit) provision from equity based compensation	(4)	15

Net cash provided by (used in) financing activities		54,451		(40,470	)
Increase (Decrease) in cash and due from banks		15,660		(24,063	)
Cash and Cash Equivalents					
Beginning of period		42,645		66,234	
End of period	$	58,305	$	42,171	

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

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

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the "Company"), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the "Bank") in August 2001. The Company's principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company's only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities. Pursuant to the Financial Accounting Standards Board's (FASB's) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. Our branch footprint stretches from Fresno on the north to Bakersfield on the south, and on the southern end extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. We currently operate 25 full service branch offices throughout our geographic footprint, as well as an internet branch which provides the ability to open deposit accounts and submit certain loan applications online. The Bank's newest "brick and mortar" branches opened for business in Selma in February 2011 and Farmersville in March 2010. In January 2011 we closed our first branch ever, in Bakersfield on California Avenue due to lease issues, and we are currently searching for a suitable location to replace that branch. In addition to our full-service branches, the Bank has an agricultural credit division and an SBA lending unit with staff located at our corporate headquarters, and offsite ATM's at eight different non-branch locations. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

Note 2 – Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. In preparing the accompanying consolidated financial statements, management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2010 have been reclassified to be consistent with the reporting for 2011. The interim financial information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission.

Note 3 – Current Accounting Developments

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

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

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

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

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

Note 4 – Supplemental Disclosure of Cash Flow Information

During the nine months ended September 30, 2011 and 2010, cash paid for interest due on interest-bearing liabilities was $3.991 million and $6.522 million, respectively. There was also $1.643 million in cash paid for income taxes during the nine months ended September 30, 2011, and $5.360 million in cash paid for income taxes during the nine months ended September 30, 2010. Assets totaling $4.663 million and $14.068 million were acquired in settlement of loans for the nine months ended September 30, 2011 and September 30, 2010, respectively, and we received $4.285 million in cash from the sale of foreclosed assets during the first nine months of 2011 relative to $4.520 million during the first nine months of 2010. The Company extended $1.506 million in loans to finance the sale of foreclosed assets during the nine months ended September 30, 2011, but none during the first nine months of 2010.

Note 5 – Share Based Compensation

The 2007 Stock Incentive Plan (the "2007 Plan") was adopted by the Company in 2007. Our 1998 Stock Option Plan (the "1998 Plan") was concurrently terminated, although options to purchase 276,630 shares that were granted prior to the termination of the 1998 Plan were still outstanding as of September 30, 2011 and remain unaffected by the termination. The 2007 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors of the Company. The 2007 Plan also provides for the potential issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although options have been granted since the inception of the plan and the number remaining available for grant as of September 30, 2011 was 1,050,440. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share. No restricted stock awards have been issued by the Company.

Pursuant to FASB's standards on stock compensation, share-based compensation expense is reflected in our income statement for each option granted over the vesting period of such option. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee's options for each vesting period are separately valued and amortized. This appears to be the preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of $48,000 was reflected in the Company's income statement during the third quarter of 2011 and $30,000 was charged during the third quarter of 2010, as compensation expense related to outstanding and unvested stock options. For the first nine months, these charges amounted to $166,000 in 2011 and $96,000 in 2010.

Note 6 – Earnings per Share

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 14,051,614 weighted average shares outstanding during the third quarter of 2011, and 11,650,137 during the third quarter of 2010. There were 14,015,583 weighted average shares outstanding during the first nine months of 2011, and 11,642,517 during the first nine months of 2010. The increase for 2011 is due primarily to the Company's issuance of 2,325,000 shares of its common stock at a price of $10 per share on October 19, 2010, in a registered direct offering to select institutional investors.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to "in-the-money" shares that would be issued on the exercise of outstanding stock options. The dilutive effect of options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the third quarter and first nine months of 2011, the dilutive effect of options outstanding calculated under the treasury stock method totaled 45,754 and 66,353, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the third quarter and first nine months of 2010, shares totaling 87,930 and 85,744, respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 – Comprehensive Income

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

Comprehensive Income (dollars in thousands, unaudited)	For the Quarter Ended September 30, 2011	For the Quarter Ended September 30, 2010	For the Nine-Month Period Ended September 30, 2011	For the Nine-Month Period Ended September 30, 2010
Net Income	$ 2,526	$ 887	$ 6,239	$ 5,771
Other comprehensive income:				
Unrealized holding gain	1,825	27	7,114	2,577
Less: reclassification adjustment	-	2,639	-	2,639
Pre-tax other comprehensive income/(loss)	1,825	(2,612)	7,114	(62)
Less: tax impact of above	768	(1,098)	2,991	(26)
Net other comprehensive income	1,057	(1,514)	4,123	(36)
Comprehensive income	$ 3,583	$ (627)	$ 10,362	$ 5,735

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

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

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	September 30, 2011	December 31, 2010
Commitments to extend credit	$ 157,120	$ 142,309
Standby letters of credit	$ 11,967	$ 7,761
Commercial letters of credit	$ 8,995	$ 9,435

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

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

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

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

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

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

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

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Company’s entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any estimates. Because no market exists for a significant portion of the Company's financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments disclosed at September 30, 2011 and December 31, 2010:

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

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

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

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

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

- Other investments: Included in other assets are certain long-term investments carried at cost, which approximates their estimated fair value.

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

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

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

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

- Commitments to extend credit and letters of credit: Commitments to extend credit are primarily for adjustable rate loans. Commitments to fund fixed rate loans and letters of credit, where such exist, are also at rates which approximate market rates at each reporting date. Thus, if funded, the carrying amounts would approximate fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not these commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

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Estimated fair values for the Company's financial instruments at September 30, 2011 and December 31, 2010 are as follows:

Fair Value of Financial Instruments (dollars in thousands, unaudited)	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 58,305	$ 58,305	$ 42,645	$ 42,645
Investment securities available for sale	$ 429,828	$ 429,828	$ 331,730	$ 331,730
Loans and leases, net	$ 738,550	$ 776,745	$ 784,515	$ 816,185
Cash surrender value of life insurance policies	$ 37,129	$ 37,129	$ 31,591	$ 31,591
Other investments	$ 7,365	$ 7,365	$ 8,361	$ 8,361
Investments in limited partnerships	$ 10,242	$ 10,242	$ 10,899	$ 10,899
Accrued interest receivable	$ 5,371	$ 5,371	$ 5,677	$ 5,677
Financial liabilities:				
Deposits	$ 1,093,619	$ 1,094,721	$ 1,052,274	$ 1,052,085
Repurchase agreements	$ 4,633	$ 4,633	$ 0	$ 0
Overnight borrowings	$ 25,000	$ 25,000	$ 9,650	$ 9,650
Short-term borrowings	$ 0	$ 0	$ 5,000	$ 5,000
Long-term borrowings	$ 15,000	$ 10,409	$ 15,000	$ 15,736
Subordinated debentures	$ 30,928	$ 11,930	$ 30,928	$ 11,610
Limited partnership capital commitment	$ 353	$ 353	$ 417	$ 417
Accrued interest payable	$ 398	$ 398	$ 678	$ 678

	Notional Amount	Notional Amount
Off-balance-sheet financial instruments:		
Commitments to extend credit	$ 157,120	$ 142,309
Standby letters of credit	$ 11,967	$ 7,761
Commercial letters of credit	$ 8,995	$ 9,435

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

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

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

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

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

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

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

	Fair Value Measurements at September 30, 2011, Using			
	Level 1	Level 2	Level 3	Total
Investment Securities				
U.S. Government agencies	$ -	$ 3,416	$ -	$ 3,416
Obligations of states and political subdivisions	-	74,527	-	74,527
U.S. Government agencies collateralized by mortgage obligations	-	350,561	-	350,561
Other Securities	1,324	-	-	1,324
Total availabe-for-sale securities	1,324	428,504	-	429,828
Loans Held for Sale	855	-	-	855
Total	$ 2,179	$ 428,504	$ -	$ 430,683

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

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

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

	Fair Value Measurements at September 30, 2011, Using			
	Level 1	Level 2	Level 3	Total
Impaired Loans	$ -	$ 34,317	$ 17,608	$ 51,925

Foreclosed Assets	$ -	$ 8,867	$ 9,318	$ 18,185

	Fair Value Measurements at December 31, 2010, Using			
	Level 1	Level 2	Level 3	Total
Impaired Loans	$ -	$ 29,482	$ 6,705	$ 36,187
Foreclosed Assets	$ -	$ 3,123	$ 17,568	$ 20,691

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

Note 10 – Investments

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB's guidance on accounting for debt and equity securities, available for sale securities are carried on the Company's financial statements at their estimated fair market value, with monthly tax-effected "mark-to-market" adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity. The Company's available-for-sale investment securities totaled $430 million at September 30, 2011, and $332 million at December 31, 2010.

At September 30, 2011 and December 31, 2010, the Company had 59 securities and 141 securities, respectively, with unrealized losses. Management has evaluated these securities as of the respective dates, and does not believe that any of the associated unrealized losses are other than temporary. Information pertaining to these investment securities, aggregated by investment category and length of time that individual securities have been in a continuous loss position, is disclosed in the table below.

Investment Portfolio - Unrealized Losses
(dollars in thousands, unaudited)

	September 30, 2011			
	Less than 12 Months		Over 12 Months	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
US Treasuries	$ -	$ -	$ -	$ -
US Government Agencies	-	-	-	-
Obligations of States and Political Subdivisions	1,181	(44)	1,784	(88)
Agency-Issued Mortgage-Backed Securities (MBS)	87,305	(689)	1,446	(10)
Private-Label MBS	-	-	256	(4)
Other Securities	-	-	1,324	(1,381)
TOTAL	$ 88,486	$ (733)	$ 4,810	$ (1,483)

	December 31, 2010			
	Less than 12 Months		Over 12 Months	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
US Treasuries	$ -	$ -	$ -	$ -
US Government Agencies	-	-	-	-
Obligations of States and Political Subdivisions	24,728	(884)	2,478	(283)
Agency-Issued Mortgage-Backed Securities (MBS)	108,203	(1,009)	-	-

Private-Label MBS	-	-	558	(21)
Other Securities	-	-	1,408	(1,292)
TOTAL	$ 132,931	$ (1,893)	$ 4,444	$ (1,596)

Note 11 – Credit Quality and Nonperforming Assets

Credit Quality Classifications

The Company monitors the credit quality of loans on a continuous basis using the regulatory and accounting classifications of pass, special mention, substandard and impaired to characterize the associated credit risk. Balances classified as “loss” are immediately charged-off. The Company uses the following definitions of risk classifications:

- Pass: Loans listed as pass include larger non-homogeneous loans not meeting the risk rating definitions below and smaller, homogeneous loans that are not assessed on an individual basis.

- Special Mention: Loans classified as special mention have potential issues that deserve the close attention of management. If left uncorrected, these potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company’s credit position at some future date.

- Substandard: Loans classified as substandard are loans with at least one clear and well-defined weakness such as a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or poor financial condition, which could jeopardize ultimate recoverability of the debt.

- Impaired: A loan is considered impaired, when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans, loans classified as restructured troubled debt, and certain other loans that are still being maintained on accrual status. If the Bank grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring (TDR). TDR’s may be classified as either nonperforming or performing loans depending on their accrual status.

Credit quality classifications for the Company's loan balances were as follows, as of the dates indicated:

Credit Quality Classifications
(dollars in thousands, unaudited)

	September 30, 2011				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 - family residential construction	$ 4,965	$ 2,658	$ -	$ 3,846	$ 11,469
Other construction/Land	18,044	9,580	1,563	13,076	42,263
1-4 Family - closed end	78,386	6,995	2,011	18,700	106,092
Equity Lines	62,489	380	1,673	2,481	67,023
Multi-family residential	4,037	439	-	2,945	7,421
Commercial RE - owner-occupied	143,182	19,335	12,439	10,150	185,106
Commercial RE - non-owner occupied	65,038	6,681	5,536	28,867	106,122
Farmland	42,907	1,887	4,638	7,509	56,941
Total Real Estate	419,048	47,955	27,860	87,574	582,437
Agricultural	14,472	1,609	28	13	16,122
Commercial and Industrial	75,700	7,250	4,200	5,654	92,804
Small Business Administration	14,232	1,461	562	3,886	20,141
Direct finance leases	6,791	77	-	706	7,574
Consumer loans	33,516	1,093	440	3,657	38,706
Total Gross Loans and Leases	$ 563,759	$ 59,445	$ 33,090	$ 101,490	$ 757,784

	December 31, 2010				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 - family residential construction	$ 4,309	$ 5,500	$ -	$ 4,057	$ 13,866
Other construction/Land	24,988	17,979	1,411	7,669	52,047
1-4 Family - closed end	83,543	6,345	2,326	12,331	104,545
Equity Lines	66,560	1,426	1,558	1,239	70,783
Multi-family residential	4,930	3,076	-	2,956	10,962
Commercial RE - owner-occupied	149,451	18,892	11,936	7,691	187,970
Commercial RE - non-owner occupied	79,842	7,498	6,051	27,109	120,500
Farmland	35,949	21,091	3,848	405	61,293
Total Real Estate	449,572	81,807	27,130	63,457	621,966
Agricultural	11,547	1,673	237	-	13,457
Commercial and Industrial	79,083	8,156	5,425	2,104	94,768
Small Business Administration	13,219	1,335	621	3,441	18,616
Direct finance leases	9,604	129	-	501	10,234

Consumer loans	42,436	830	775	1,544	45,585
Total Gross Loans and Leases	$ 605,461	$ 93,930	$ 34,188	$ 71,047	$ 804,626

Past Due and Nonperforming Assets

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and other real estate owned (“OREO”). OREO consists of properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt exists with regard to the ability of the Company to collect all principal and interest on a loan or lease. At that point, we stop accruing interest on the loan or lease in question, and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for a period of 90 days or more is also placed on non-accrual status, even if interest is still being received, unless the asset is both well secured and in the process of collection. An aging of the Company’s loan balances, by number of days past due as of the indicated dates, is presented in the following table:

Loan Portfolio Aging
(dollars in thousands, unaudited)

September 30, 2011	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans (1)
Real Estate:							
1-4 family residential construction	$ 175	$ -	$ 323	$ 498	$ 10,971	$ 11,469	$ 3,846
Other construction/land	804	832	1,900	3,536	38,727	42,263	5,227
1-4 family - closed-end	1,765	39	2,196	4,000	102,092	106,092	6,412
Equity Lines	511	403	1,331	2,245	64,778	67,023	2,481
Multi-family residential	2,945	-	-	2,945	4,476	7,421	-
Commercial RE - owner occupied	4,427	1,748	6,823	12,998	172,108	185,106	8,921
Commercial RE - non-owner occupied	206	5,381	970	6,557	99,565	106,122	10,425
Farmland	7,253	-	188	7,441	49,500	56,941	492
Total Real Estate	18,086	8,403	13,731	40,220	542,217	582,437	37,804
Agricultural	-	-	-	-	16,122	16,122	-
Commercial and Industrial	1,241	901	4,061	6,203	86,601	92,804	4,432
Small Business	568	-	2,929	3,497	16,644	20,141	3,776
Direct finance leases	76	-	707	783	6,791	7,574	707
Consumer loans	1,087	531	820	2,438	36,268	38,706	1,825
Total Gross Loans and Leases	$ 21,058	$ 9,835	$ 22,248	$ 53,141	$ 704,643	$ 757,784	$ 48,544

December 31, 2010	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans (1)
Real Estate:							
1-4 family residential construction	$ 4,075	$ -	$ -	$ 4,075	$ 9,791	$ 13,866	$ 4,057
Other construction/land	9,662	1,385	7,563	18,610	33,437	52,047	6,185
1-4 family - closed-end	5,902	80	2,210	8,192	96,353	104,545	4,894
Equity Lines	758	110	1,130	1,998	68,785	70,783	1,239
Multi-family residential	2,634	-	-	2,634	8,328	10,962	-
Commercial RE - owner occupied	1,141	1,255	6,788	9,184	178,786	187,970	7,412

Commercial RE - non-owner occupied	9,881	918	4,654	15,453	105,047	120,500	14,704
Farmland	-	-	214	214	61,079	61,293	405
Total Real Estate	34,053	3,748	22,559	60,360	561,606	621,966	38,896
Agricultural	-	-	-	-	13,457	13,457	-
Commercial and Industrial	1,977	669	1,281	3,927	90,841	94,768	2,005
Small Business	19	-	2,927	2,946	15,670	18,616	3,440
Direct finance leases	129	-	501	630	9,604	10,234	501
Consumer loans	954	319	850	2,123	43,462	45,585	1,112
Total Gross Loans and Leases	$ 37,132	$ 4,736	$ 28,118	$ 69,986	$ 734,640	$ 804,626	$ 45,954

(1) Included in Total Financing Receivables

Troubled Debt Restructurings

A loan that is modified for a borrower who is experiencing financial difficulty is classified as a troubled debt restructuring ("TDR"), if the modification constitutes a concession. At September 30, 2011, the Company had a total of $54.3 million in TDR's, including $19.9 million in TDR's that were on non-accrual status. The Company typically places a TDR on non-accrual status and ceases accruing interest when loan payment performance is deemed unsatisfactory, generally at 90 days past due. Additionally, whenever a notice of default or disposition is filed on a loan the loan is placed on non-accrual. A TDR is generally considered to be in default when it appears likely that the customer will not be able to repay all principal and interest pursuant to the terms of the restructured agreement. TDR's may be restored to accrual status when there has been satisfactory repayment performance for a period that is normally not less than 6 months, and the Company reasonably believes that it will continue to receive all future principal and interest pursuant to the terms of the agreement. TDR's may be removed from TDR designation in the calendar year following the restructuring, if the loan is in compliance with all modified terms and is yielding a market rate of interest.

The Company may agree to different types of concessions when modifying a loan or lease. The table below summarizes TDR modifications by type of concession, for the noted periods:

Troubled Debt Restructurings, by Type of Loan Modification
(dollars in thousands, unaudited)

Three Months Ended September 30, 2011

	Rate	Term	Interest-Only	Rate & Term	Rate & Interest-Only	Term & Interest-Only	Rate, Term & Interest-Only	Total
Trouble Debt Restructurings								
Real Estate:								
Other construction/Land	$ -	$ 291	$ -	$ -	$ -	$ 5,758	$ -	$ 6,049
1-4 family - closed-end	-	6,455	-	-	-	-	382	6,837
Equity Lines	-	-	436	-	-	-	-	436
Commercial RE - owner-occupied	-	-	-	-	-	-	-	-
Comm'l RE - non-owner occupied	7,405	68	-	-	-	-	-	7,473
Subtotal Real Estate	7,405	6,814	436	-	-	5,758	382	20,795
Agricultural Products	-	-	-	-	-	-	15	15
Commercial and Industrial	20	181	24	753	-	51	-	1,029
Consumer loans	281	461	-	1,111	-	-	37	1,890
Small Business Admin Loans	-	247	106	-	-	-	-	353
	$ 7,706	$ 7,703	$ 566	$ 1,864	$ -	$ 5,809	$ 434	$ 24,082

Nine Months Ended September 30, 2011

	Rate	Term	Interest-Only	Rate & Term	Rate & Interest-Only	Term & Interest-Only	Rate, Term & Interest-Only	Total
Trouble Debt Restructurings								
Real Estate:								
Other construction/Land	$ -	$ 665	$ -	$ 234	$ -	$ 6,238	$ -	$ 7,137
1-4 family - closed-end	-	6,455	-	-	158	-	424	7,037
Equity Lines	-	-	436	-	-	-	-	436
Commercial RE - owner-occupied	-	-	-	-	542	-	-	542
Comm'l RE - non-owner occupied	7,405	68	-	875	3,230	-	-	11,578

Subtotal Real Estate	7,405	7,188	436	1,109	3,930	6,238	424	26,730
Agricultural Products	-	-	-	-	-	-	15	15
Commercial and Industrial	20	336	24	753	-	187	-	1,320
Consumer loans	281	461	-	1,337	147	-	37	2,263
Small Business Admin Loans	-	247	106	-	-	-	-	353
	$ 7,706	$ 8,232	$ 566	$ 3,199	$ 4,077	$ 6,425	$ 476	$ 30,681

The following table presents, by class, additional details related to loans classified as TDR's during the three and nine months ended September 30, 2011, including the recorded investment in the loan both before and after modification and balances that were modified during the period and subsequently defaulted:

Troubled Debt Restructurings
(dollars in thousands, unaudited)

	Three Months ended September 30, 2011				Subsequent Default	
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference (1)	Number of Loans	Recorded Investment
Real Estate:						
Other Construction/Land	10	$ 6,061	$ 6,049	$ (67)	-	$ -
1-4 family - closed-end	4	6,837	6,837	(6)	-	-
Equity Lines	2	436	436	33	-	-
Commercial RE- owner occupied	-	-	-	-	-	-
Comm'l RE- non-owner occupied	2	7,522	7,473	(7)	1	68
Agricultural products	1	15	15	-	-	-
Commercial and Industrial	12	1,032	1,029	53	-	-
Small Business Admin Loans	5	353	353	38	-	-
Consumer loans	33	1,890	1,890	(135)	-	-
		$ 24,146	$ 24,082	$ (91)		$ 68

	Nine Months ended September 30, 2011				Subsequent Default	
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference (1)	Number of Loans	Recorded Investment
Real Estate:						
Other Construction/Land	16	$ 7,149	$ 7,137	$ -	-	$ -
1-4 family - closed-end	7	7,038	7,038	(5)	-	-
Equity Lines	2	436	436	33	-	-
Commercial RE- owner occupied	1	542	542	3	-	-
Comm'l RE- non-owner occupied	5	11,627	11,578	(111)	1	68
Agricultural products	1	15	15	-	-	-
Commercial and Industrial	14	1,322	1,320	16	-	-
Small Business Admin Loans	5	353	353	38	-	-
Consumer loans	41	2,263	2,262	(114)	-	-
		$ 30,745	$ 30,681	$ (140)		$ 68

(1) This represents the change in the allocated loss allowance due to any change in reserve methodology subsequent to modification

In the table above, the TDR’s that subsequently defaulted increased our allowance for loan and lease losses by $5,000 for the three months and nine months ended September 30, 2011, and none of the TDR defaults have resulted in charge-offs. The total allowance for loan and lease losses specifically allocated to the balances that were classified as TDR’s during the nine months ended September 30, 2011 was $951,000 at September 30, 2011.

Note 12 – Allowance for Loan and Lease Losses

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses based on management's evaluation of probable loan losses on certain specifically identified loans, as well as probable incurred losses inherent in the remaining loan portfolio. It is maintained at a level that is considered adequate to absorb remaining probable loan losses, after factoring in charge-offs taken against the allowance and recoveries credited back to the allowance. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it on at least a quarterly basis. Pursuant to that methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary. The following tables disclose the unpaid principal balance, recorded investment (including accrued interest), average recorded investment, and interest income recognized for impaired loans on our books as of the dates indicated. Balances are shown by loan type, and are further broken out by those that required an allowance and those that did not, with the associated allowance disclosed for those that required such.

Impaired Loans
(dollars in thousands, unaudited)

	September 30, 2011				
	Unpaid Principal Balance (1)	Recorded Investment (2)	Related Allowance	Average Recorded Investment	Interest Income Recognized (3)
With an Allowance Recorded					
Real Estate:					
Const. & land development	$ 9,007	$ 7,175	$ 2,134	$ 9,591	$ 66
1-4 Family residential	7,422	7,543	1,943	7,742	80
Multifamily residential	2,944	2,984	54	2,993	113
Commercial RE and Other	29,626	30,414	3,124	31,359	415
Commercial and Industrial	9,722	9,861	3,303	10,063	11
Consumer and Other	3,403	3,453	639	3,550	28
	$ 62,124	$ 61,430	$ 11,197	$ 65,298	$ 713
With no Related Allowance Recorded					
Real Estate:					
Const. & land development	$ 13,005	$ 11,291	$ -	$ 14,312	$ 117
1-4 Family residential	7,750	7,560	-	8,038	133
Multifamily residential	-	-	-	-	-
Commercial RE and Other	23,287	23,676	-	24,569	39
Commercial and Industrial	566	581	-	607	5
Consumer and Other	255	258	-	265	3
	44,863	43,366	-	47,791	297
Total	$ 106,987	$ 104,796	$ 11,197	$ 113,089	$ 1,010

	December 31, 2010				
	Unpaid Principal Balance (1)	Recorded Investment (2)	Related Allowance	Average Recorded Investment	Interest Income Recognized (3)
With an Allowance Recorded					
Real Estate:					
Const. & land development	$ 6,493	$ 5,306	$ 1,544	$ 10,938	$ 43
1-4 Family residential	8,047	8,208	1,068	8,279	181
Multifamily residential	2,956	2,963	37	2,966	212
Commercial RE and Other	15,749	16,216	2,580	18,203	155
Commercial and Industrial	6,065	6,114	2,235	6,670	1
Consumer and Other	1,170	1,205	565	1,227	18
	$ 40,480	$ 40,012	$ 8,029	$ 48,283	$ 610
With no Related Allowance Recorded					
Real Estate:					
Const. & land development	$ 10,264	$ 7,670	$ -	$ 11,545	$ 129
1-4 Family residential	5,782	5,607	-	5,964	99
Multifamily residential	-	-	-	-	-
Commercial RE and Other	19,456	19,920	-	20,140	736
Commercial and Industrial	6	6	-	9	-
Consumer and Other	374	377	-	395	1

		35,882		33,580		-		38,053		965
Total	$	76,362	$	73,592	$	8,029	$	86,336	$	1,575

(1) Contractual principal balance due from customer
(2) Principal balance on Company's books, plus unamortized deferred loan costs and unpaid accrued interest, less unamortized deferred loan fees
(3) Interest income is recognized on performing balances only, on a regular accrual basis

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Similar but condensed information for the periods noted is provided in the following table:

Impaired Loans
(dollars in thousands, unaudited)

	September 30, 2011	December 31, 2010
Impaired loans without a valuation allowance	$ 41,901	$ 32,035
Impaired loans with a valuation allowance	59,589	39,012
Total impaired loans (1)	$ 101,490	$ 71,047
Valuation allowance related to impaired loans	$ 11,197	$ 8,029
Total non-accrual loans	$ 48,544	$ 49,954
Total loans past-due ninety days or more and still accruing	$ -	$ -

(1) Principal balance only

The specific loss allowance for an impaired loan represents the difference between the face value of the loan and either its current appraised value less estimated disposition costs, or its net present value as determined by a discounted cash flow analysis. The discounted cash flow approach is used to measure impairment on loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition of underlying collateral. Any change in impairment attributable to the passage of time is adjusted for by means of adjustments to the loan loss provision. If a distressed borrower displays the desire and ability to continue paying on the loan, but is unable to do so except on a modified basis, an amended repayment plan may be negotiated. For these TDR's, the act of modification in and of itself suggests that the Company believes the source of repayment will likely be from borrower-generated cash flows, thus they are also typically evaluated for impairment by discounting projected cash flows. Included in the valuation allowance for impaired loans shown in the table above are specific reserves allocated to TDR's, totaling $2.832 million at September 30, 2011, and $2.973 million at December 31, 2010.

For loans where repayment is expected to be provided solely by the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition, is less than the loan balance, then a specific loss reserve is established for the amount of the collateral coverage shortfall. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is established. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal was not already available. We generally use external appraisals to determine the fair value of the underlying collateral for nonperforming real estate loans, although the Company's licensed staff appraisers may update older appraisals based on current market conditions and property value trends. Until an updated appraisal is received, the Company uses the existing appraisal to determine the amount of the specific loss allowance that may be required, and adjusts the specific loss allowance, as necessary, once a new appraisal is received. Updated appraisals are generally ordered at least annually for collateral-dependent loans that remain impaired. Current appraisals were available for 75% of the Company's impaired loan balances at September 30, 2011. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if such costs were not reflected in appraised values. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Our methodology also provides that a "general" allowance be established for probable incurred losses inherent in loans and leases that are not impaired. These unimpaired loan balances are segregated by credit quality, and are then evaluated in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical loss data and other measurable information, the classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on management's judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that management believes is appropriate at each reporting date. Quantitative information includes our historical loss experience, delinquency and charge-off trends, current collateral values, and the anticipated timing of collection of principal for nonperforming loans. Qualitative factors include the general economic environment in our markets and, in particular, the state of the agricultural industry and other key industries in the Central San Joaquin Valley. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The total general reserve established for probable incurred losses on unimpaired loans was $9.3 million at September 30, 2011.

During the quarter ended September 30, 2011, there were no material changes made to the methodology used to determine our allowance for loan and lease losses. As we add new products and expand our geographic coverage, and as the economic environment changes, we expect to continue to enhance our methodology to keep pace with the size and complexity of the loan and lease portfolio and respond to pressures created by external forces. We engage outside firms on a regular basis to assess our methodology and perform independent credit reviews of our loan and lease portfolio. In addition, the Company's external auditors, the FDIC, and the California DFI review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity. The table that follows details the activity in the allowance for loan and lease losses for the quarter and the nine months ended September 30, 2011:

Allowance for Credit Losses and Recorded Investment in Financing Receivables
(dollars in thousands, unaudited)

	For the Quarter Ended September 30, 2011						
	Real Estate	Ag products	Comm'l & Industrial	SBA Loans	Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning Balance	$ 10,427	$ 16	$ 5,771	$ 1,269	$ 463	$ 2,765	$ 20,711
Charge-offs	2,129	-	592	3	23	718	3,465
Recoveries	10	-	120	-	31	85	246
Provision	2,463	3	(376)	196	(43)	757	3,000
Ending Balance	$ 10,771	$ 19	$ 4,923	$ 1,462	$ 428	$ 2,889	$ 20,492

	For the Nine Months Ended September 30, 2011						
	Real Estate	Ag products	Comm'l & Industrial	SBA Loans	Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning Balance	$ 10,142	$ 62	$ 5,797	$ 1,274	$ 284	$ 3,579	$ 21,138
Charge-offs	6,250	-	2,402	128	33	2,048	10,861
Recoveries	61	-	245	69	45	195	615
Provision	6,818	(43)	1,283	247	132	1,163	9,600
Ending Balance	$ 10,771	$ 19	$ 4,923	$ 1,462	$ 428	$ 2,889	$ 20,492
Ending balance: individually evaluated for impairment	$ 7,255	$ 2	$ 1,691	$ 1,281	$ 329	$ 639	$ 11,197
Ending balance: collectively evaluated for impairment	$ 3,516	$ 17	$ 3,232	$ 181	$ 99	$ 2,250	$ 9,295
Ending balance: loans acquired with deteriorated credit quality	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Financing receivables:							
Ending Balance	$ 582,437	$ 16,122	$ 92,804	$ 20,141	$ 7,574	$ 38,706	$ 757,784
Ending balance: individually evaluated for impairment	$ 87,574	$ 12	$ 5,654	$ 3,886	$ 707	$ 3,657	$ 101,490
Ending balance: collectively evaluated for impairment	$ 494,863	$ 16,110	$ 87,150	$ 16,255	$ 6,867	$ 35,049	$ 656,294
Ending balance: loans acquired with deteriorated credit quality	$ -	$ -	$ -	$ -	$ -	$ -	$ -

PART I - FINANCIAL INFORMATION

ITEM 2

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

FORWARD-LOOKING STATEMENTS

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

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

CRITICAL ACCOUNTING POLICIES

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

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan and lease losses, as explained in detail in Note 12 to the consolidated financial statements and the "Provision for Loan and Lease Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, which is discussed in Note 11 to the consolidated financial statements and in the "Nonperforming Assets" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on the fair value of the Company and for which it has been determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.

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OVERVIEW OF THE RESULTS OF OPERATIONS AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

Third Quarter 2011 compared to Third Quarter 2010

Net income for the quarter ended September 30, 2011 was $2.526 million, representing an increase of $1.639 million, or 185%, relative to net income of $887,000 for the quarter ended September 30, 2010. Basic and diluted earnings per share for the third quarter of 2011 were $0.18, compared to $0.08 basic and diluted earnings per share for the third quarter of 2010. The Company's annualized return on average equity was 6.00% and annualized return on average assets was 0.74% for the quarter ended September 30, 2011, compared to a return on equity of 2.49% and return on assets of 0.27% for the quarter ended September 30, 2010. The primary drivers behind the variance in net income are as follows:

- Net interest income was down $475,000, or 3%, due to a 29 basis point drop in the Company's net interest margin, partially offset by a $35 million increase in average interest-earning assets. The primary negative factor impacting our net interest margin in the third quarter of 2011 was a shift from average loan balances into lower-yielding investment balances. This was partially offset by a reduced reliance on interest-bearing liabilities that was facilitated by increases in the average balances of non-interest bearing demand deposits and equity, a shift in average balances from time deposits (including CDAR's) and non-deposit borrowings into lower-cost core deposits, a lower level of net interest reversals on loans placed on non-accrual, and a lower level of nonperforming loans.

- The Company's loan loss provision was reduced by $3.380 million, or 53%. Thus far in 2011 our loan loss provision has been utilized to provide specific reserves for impaired loans and to replenish reserves subsequent to loan charge-offs, with the reserve requirement offset in part by the release of general reserves for unimpaired loans as loan balances have declined. Net loans charged off totaled $3.219 million in the third quarter of 2011, relative to net charge-offs of $11.420 million in the third quarter of 2010.

- Total non-interest revenue declined by $3.684 million, or 52%, due primarily to a $2.639 million nonrecurring gain on investments in the third quarter of 2010 relative to no investment gains in 2011. Adding to the negative variance were a substantial drop in overdraft income resulting from procedural changes implemented pursuant to regulatory guidance, and a large drop in income recognized on bank-owned life insurance (BOLI) due to losses in 2011 on BOLI associated with deferred compensation plans. Partially offsetting these unfavorable differences was a reduction in costs associated with low-income housing tax credit investments resulting from accrual adjustments made in the third quarter of 2011, although similar adjustments were made in the second quarter of 2010 so year-to-date tax-credit costs actually reflect a slight increase. These costs are accounted for as a reduction in income.

- Total operating expense dropped $4.027 million, or 28%, due in large part to a $3.647 million decline in expenses associated with other real estate owned (OREO), including OREO write-downs. The Company also adjusted its accrual for FDIC assessments in the third quarter of 2011 to more accurately reflect expectations for actual billings for 2011, thereby contributing to a $526,000 decline in FDIC costs in the third quarter of 2011, and deferred compensation accruals for the Company's directors dropped by $328,000 for the quarterly comparison due to losses on directors' deferred compensation plans in 2011. Salaries and benefits, on the other hand, increased by $267,000, or 6%, due mainly to the partial reversal of accrued bonuses in the third quarter of 2010, although that impact was partially offset by a drop in deferred compensation expense due to losses on deferred compensation plans in 2011 (related to the reduction in BOLI income noted above), and an increase in the level of salaries that are directly related to successful loan originations and are thus deferred and amortized over the life of the related loans.

- The Company recorded an income tax provision of $822,000, or 25% of pre-tax income, in the third quarter of 2011, relative to a negative tax provision in the third quarter of 2010 resulting from the pre-tax loss in that quarter. The provision rate in the third quarter of 2011 is higher than in recent quarters, primarily because of a drop in tax-exempt BOLI income and an increase in taxable income relative to the Company's available tax credits.

First Nine Months of 2011 Compared to First Nine Months of 2010

Net income for the first nine months of 2011 was $6.239 million, an increase of $468,000, or 8%, relative to net income for the first nine months of 2010. Basic and diluted earnings per share were $0.45 and $0.44, respectively, for the first nine months of 2011, compared to $0.50 basic earnings per share and $0.49 diluted earnings per share for the first nine months of 2010. The Company realized an annualized return on average equity of 5.09% for the first nine months of 2011 and 5.56% for the first nine months of 2010, and a return on assets for the same periods of 0.63% and 0.58%, respectively. The principal reasons for the net income variance for the comparative year-to-date periods include the following:

- Net interest income declined by $2.471 million, or 6%, due to a 29 basis point net interest margin decline partially offset by a $6 million increase in average interest-earning assets. The drop in our net interest margin for the comparative year-to-date periods was the result of the same circumstances summarized for the quarterly comparison.

- The Company's provision for loan losses was $9.600 million in the first nine months of 2011, which represents a drop of $3.680 million, or 28%, relative to the first nine months of 2010. Net charge-offs declined by $6.915 million, or 40%, for the comparable periods.

- Total non-interest income declined by $4.485 million, or 30%. The largest changes in the components of non-interest income for the year-to-date comparison include a $2.639 million drop in investment gains, lower overdraft fee income, lower BOLI income, and declining income from operating leases, partially offset by a higher level of debit card interchange fees.

- Total non-interest expense reflects a drop of $4.491 million, or 12%, for the first nine months of 2011. The largest factor was a $3.172 million decline in foreclosed asset expenses, and other significant reductions within this category are evident in occupancy expense, FDIC assessments, directors' deferred compensation expense, and costs associated with online-only deposit accounts. A total of $181,000 in non-recurring vendor credits for prior-year overcharges on processing software, which were received in the first quarter of 2011, also had a positive impact on non-interest expense for the year-to-date comparison.

- The Company recorded an income tax provision of $774,000, or 11% of pre-tax income, for the first nine months of 2011, as compared to a provision of only $27,000 for the first nine months of 2011 that resulted in a tax accrual rate of less than 1%.

FINANCIAL CONDITION SUMMARY

September 30, 2011 relative to December 31, 2010

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

- The Company's assets totaled $1.351 billion at September 30, 2011, an increase of $65 million, or 5%, relative to total assets of $1.287 billion at December 31, 2010. Total assets increased due to growth in investment securities and an increase in cash and balances due from banks, less loan runoff. Gross loan and lease balances declined $47 million, or 6%, due to runoff in the normal course of business, prepayments, transfers to OREO, and charge-offs. Weak loan demand from quality borrowers and aggressive competition have hindered our ability to counteract this contraction.

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The $67 million balance of nonperforming assets at September 30, 2011 is about the same as the balance at year-end 2010, but is well below the $77 million balance reported at September 30, 2010. In addition to nonperforming assets, the Company had $34 million in performing restructured troubled debt (TDR's) as of September 30, 2011, an increase of $22 million, or 176%, relative to year-end 2010. The increase in TDR's is primarily due to the restructuring of loans associated with two relatively large relationships, in order to ensure the borrowers' continued ability to service the loans.

- Our allowance for loan and lease losses was $20.5 million as of September 30, 2011, which represents a slight decline relative to the balance at year-end 2010 due primarily to the charge-off of pre-established specific reserves that were included in the allowance at December 31, 2010. Even though the allowance for loan and lease losses fell slightly, our allowance as a percentage of total loans increased by 8 basis points, to 2.70% at September 30, 2011 from 2.62% at December 31, 2010, because loan balances fell during the first nine months of the year.

- Total deposits increased by $41 million, or 4%. Core non-maturity deposits actually increased by $47 million, or 7%, although there was a noticeable shift from money market deposits into a new interest-bearing demand account for businesses that was introduced in August 2011. Customer time deposits, including CDARS, declined by $21 million, or 5%, due to the non-renewal of time deposits managed by our Treasury Department. We also added $15 million in longer-term wholesale-sourced brokered deposits in order to create a more defensive posture for the eventuality of rising interest rates, and short-term Federal Home Loan Bank borrowings increased by $10 million. Other borrowings increased by $5 million subsequent to a customer's transfer of balances from money market deposits into a non-deposit sweep account.

- Total capital increased by $9 million, or 5%, to $168 million at September 30, 2011. Because capital increased and risk-adjusted assets declined, our consolidated total risk-based capital ratio increased to 21.57% at September 30, 2011 from 20.33% at year-end 2010. Further, our tier one risk-based capital ratio was 20.31% and our tier one leverage ratio was 13.78% at September 30, 2011.

EARNINGS PERFORMANCE

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

NET INTEREST INCOME AND NET INTEREST MARGIN

For the third quarter of 2011 relative to the third quarter of 2010 net interest income declined by $475,000, or 3%, and for the year-to-date comparison net interest income declined by $2.471 million, or 6%. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volume of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

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

Average Balances and Rates (dollars in thousands, except per share data)	For the Quarter Ended September 30, 2011 (1) (2) (3)			For the Quarter Ended September 30, 2010 (1) (2) (3)		
	Average Balance	Income/ Expense	Average Rate/Yield	Average Balance	Income/ Expense	Average Rate/Yield
Assets						
Investments:						
Federal funds sold/due from time	$ 35,763	$ 23	0.25 %	$ 11,832	$ 8	0.26 %
Taxable	340,428	2,420	2.78 %	248,647	2,131	3.35 %
Non-taxable	74,630	716	5.78 %	71,401	695	5.86 %
Equity	1,564	-	0.00 %	1,404	-	0.00 %
Total Investments	452,385	3,159	3.07 %	333,284	2,834	3.77 %
Loans and Leases: (4) (5)						
Agricultural	14,455	162	4.45 %	10,090	134	5.27 %
Commercial	101,487	1,465	5.73 %	111,574	1,678	5.97 %
Real Estate	550,405	9,093	6.55 %	610,432	10,039	6.52 %
Consumer	38,658	971	9.97 %	49,193	1,079	8.70 %
Direct Financing Leases	6,240	89	5.66 %	10,432	144	5.48 %
Other	48,267	-	0.00 %	52,246	-	0.00 %
Total Loans and Leases	759,512	11,780	6.15 %	843,967	13,074	6.15 %
Total Interest Earning Assets (5)	1,211,897	14,939	5.02 %	1,177,251	15,908	5.49 %
Other Earning Assets	7,528			8,861		
Non-Earning Assets	131,936			137,745		
Total Assets	$ 1,351,361			$ 1,323,857		
Liabilities and Shareholders' Equity						
Interest Bearing Deposits:						
Demand Deposits	$ 28,206	$ 58	0.82 %	$ -	$ -	0.00 %
NOW						