VEECO INSTRUMENTS INC
Form DEF 14A
March 19, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant o

Check the appropriate box:

o	Preliminary Proxy Statement
o	**Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
x	Definitive Proxy Statement
o	Definitive Additional Materials
o	Soliciting Material under §240.14a-12

Veeco Instruments Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x	No fee required.	
o	Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.	
	(1)	Title of each class of securities to which transaction applies:
	(2)	Aggregate number of securities to which transaction applies:
	(3)	Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):
	(4)	Proposed maximum aggregate value of transaction:
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o	Fee paid previously with preliminary materials.	
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Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

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(4) Date Filed:

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1 Terminal Drive • Plainview, New York 11803 U.S.A. • Phone (516) 677-0200 • Fax (516) 677-0380 • www.veeco.com

March 19, 2018

2018 Annual Meeting of Stockholders

Dear Fellow Stockholder:

It is my pleasure to invite you to join me at the 2018 Annual Meeting of Stockholders of Veeco Instruments Inc. to be held on Thursday, May 3, 2018, at 8:30 a.m. Eastern Time, at 333 South Service Road, Plainview, New York 11803.

At this year s meeting, we will vote on the election of two directors and on the ratification of KPMG LLP as Veeco s independent registered public accounting firm. We will also conduct a non-binding advisory vote to approve the compensation of the Company s named executive officers.

We use the U.S. Securities and Exchange Commission rule that allows companies to furnish proxy materials to their stockholders over the internet. We believe this expedites stockholder s receipt of proxy materials, lowers annual meeting costs and conserves natural resources. Thus, we are mailing to many stockholders a Notice of Internet Availability of Proxy Materials (Notice), rather than copies of the Proxy Statement and our 2017 Annual Report to Stockholders on Form 10-K. The Notice contains instructions on how to access the proxy materials online, vote online and obtain your copy of our proxy materials.

Your vote is very important. I encourage you to sign and return your proxy card, or use telephone or internet voting prior to the meeting, so that your shares will be represented and voted at the meeting.

Sincerely,

John R. Peeler

Chairman and Chief Executive Officer

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VEECO INSTRUMENTS INC.

NOTICE OF 2018 ANNUAL MEETING OF STOCKHOLDERS

DATE AND TIME:	Thursday, May 3, 2018, 8:30 a.m., Eastern Time
PLACE:	333 South Service Road, Plainview, New York 11803
ITEMS OF BUSINESS:	1. To elect two directors to hold office until the 2021 Annual Meeting of Stockholders; 2. To hold a non-binding advisory vote on 2017 named executive officer compensation; 3. To ratify the appointment of KPMG LLP as our independent registered public accounting firm for 2018; and 4. To consider such other business as may properly come before the meeting.
WHO CAN VOTE:	You must be a stockholder of record at the close of business on March 12, 2018 to vote at the Annual Meeting.
INTERNET AVAILABILITY:	We are using the internet as our primary means of furnishing proxy materials to most of our stockholders. Rather than sending those stockholders a paper copy of our proxy materials, we are sending them a notice with instructions for accessing the materials and voting via the internet. **This Proxy Statement and our 2017 Annual Report on Form 10-K are available free of charge at www.veeco.com.**
PROXY VOTING:	We cordially invite you to participate in the Annual Meeting, either by attending and voting in person or by voting through other acceptable means. Your participation is important, regardless of the number of shares you own. You may vote by telephone, through the internet or by mailing your completed proxy card.

By order of the Board of Directors,

Gregory A. Robbins
Senior Vice President, General Counsel and Secretary

March 19, 2018
Plainview, New York

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PROXY STATEMENT SUMMARY

To assist you in reviewing the proposals to be acted upon at the Veeco Instruments Inc. (Veeco or the Company) 2018 Annual Meeting of Stockholders (the Annual Meeting), we call your attention to the following information about the proposals and voting recommendations, the Company s director nominees, and highlights of the Company s corporate governance and executive compensation. The following description is only a summary. For more complete information about these topics, please review the complete proxy statement.

Proposals and Voting Recommendations

Voting Matters		Board Vote Recommendation
Proposal 1:	Election of two nominees named herein as directors	FOR each nominee
Proposal 2:	Advisory vote to approve the compensation of our Named Executive Officers, or Say on Pay	FOR
Proposal 3:	Ratification of the appointment of our independent registered public accounting firm for 2018	FOR

Summary of Information Regarding the Board of Directors

Members of Veeco s Board of Directors (Board of Directors or the Board) are listed below. Messrs. D Amore and Jackson have been nominated for re-election to the Board.

				Committee Membership			
Name	Age	Director since	Independent (1)	AC	CC	GC	SPC
Kathleen A. Bayless	61	2016	Yes	M/FE			
Richard A. D Amore	64	1990	Yes (Lead Independent Director)		M		M
Gordon Hunter	66	2010	Yes		C	M	M
Keith D. Jackson	62	2012	Yes	M/FE		C	
John R. Peeler	63	2007	No				C
Peter J. Simone	70	2004	Yes	C/FE		M	M
Thomas St. Dennis	64	2016	Yes		M		M

(1) Independence determined based on NASDAQ rules.

AC	Audit Committee	**C**	Chairperson
CC	Compensation Committee	**M**	Member
GC	Governance Committee	**FE**	Audit committee financial expert (as determined based on SEC rules)
SPC	Strategic Planning Committee		

Corporate Governance Highlights

Board and Other Governance Information	As of March 19, 2018
Size of Board as Nominated	7
Average Age of Director Nominees and Continuing Directors	64
Average Tenure of Director Nominees and Continuing Directors	8.7 years
Percentage of Continuing Directors and Nominees who are Independent	85.7%
Percentage of Directors who attended all Board Meetings	100%
Number of Director Nominees and Continuing Directors Who Serve on More Than Three Public Company Boards	0
Directors Subject to Stock Ownership Guidelines (3 times annual cash retainers)	Yes
Annual Election of Directors	No
Voting Standard	Majority

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Board and Other Governance Information	As of March 19, 2018
Plurality Voting Carve-out for Contested Elections	Yes
Separate Chairman and CEO	No
Lead Independent Director	Yes
Independent Directors Meet Without Management Present	Yes
Annual Board, Committee and Individual Director Self-Evaluations, Including Use of External Governance Advisor at Least Every 3 Years	Yes
Annual Independent Director Evaluation of CEO	Yes
Risk Oversight by Full Board and Committees	Yes
Board Orientation/Education Program	Yes
Code of Conduct Applicable to Directors	Yes
Stockholder Ability to Call Special Meetings	50% of Outstanding Shares
Stockholder Ability to Act by Written Consent	No
Poison Pill	No

Executive Compensation Highlights

Here s What We Do

Pay for Performance. We ensure that the compensation of the Chief Executive Officer (CEO) and the other named executive officers listed in the Summary Compensation Table below (collectively, the NEOs) tracks the Company s performance. Our compensation programs reflect our belief that the ratio of performance-based compensation to fixed compensation should increase with the level of the executive, with the greatest amount of performance-based compensation at the CEO level.

Peer Group Selection. We made changes to our Peer Group for 2017 to more appropriately reflect our industry and size as measured by revenue and market capitalization. As a result, certain of the companies previously included in our peer group were removed for 2017 based on their much larger size.

Performance-based Long Term Incentives. The majority of the long term incentive compensation provided to our CEO and other NEOs is awarded in the form of performance-based restricted stock units that feature a minimum three-year target performance period, are capped at 150% of target, and are subject to 100% forfeiture.

Minimum Vesting. Our 2010 Stock Incentive Plan specifies a one year minimum vesting period for all equity awards (including, beginning in 2017, stock option awards), except for up to 5% of the maximum number of shares available or in the event of certain circumstances (e.g., death, disability, corporate transactions). Time-based awards granted to executives feature vesting periods ranging from three to four years.

Stock Option Provisions. Our 2010 Stock Incentive Plan prohibits the cash buyout of underwater stock options and the repricing of stock options without stockholder approval; the Company has not engaged in either of these practices.

Double-Trigger Change in Control Arrangements. Our Senior Executive Change in Control Policy features a narrow change in control definition, requiring an actual change in control and termination of employment before change in control benefits are triggered. The situations where an executive is eligible to resign with good reason are limited to: (i) reductions in base salary, (ii) relocation by more than 50 miles, (iii) significant reductions in total benefits, for Messrs. Peeler and Maheshwari only, and (iv) for Mr. Peeler only, a diminution in position.

These provisions are not triggered by bankruptcy. See Potential Payments Upon Termination or Change in Control below for more information.

Clawback Policy. Our Compensation Recoupment Policy provides that in the event of a financial restatement due to fraud or intentional illegal conduct as determined by the independent members of the Board of Directors, a culpable executive officer may be required to reimburse the Company for performance-based cash compensation if the amount of such compensation would have been lower had it been calculated based on such restated financial statements.

Stock Ownership Guidelines. Our stock ownership guidelines require our NEOs and our Board of Directors to hold Veeco stock in a specified multiple of their base salaries or annual cash retainers, subject to a phase-in period. For example, Veeco s CEO is required to hold Veeco stock with a value equal to at least four times his base salary. Pursuant to these guidelines, covered individuals are required to hold at least 50% of the net after-tax shares realized upon vesting or exercise until the ownership guidelines are met.

Hedging and Pledging Restrictions. Our insider trading policy prohibits all employees and directors from hedging or pledging their Veeco shares.

Annual Bonus. Amounts that can be earned under our annual incentive programs are based solely on performance against corporate financial and individual goals. Awards under the programs are not guaranteed and are capped at 200% of target.

Annual Say-on-Pay Vote. We conduct an annual Say-on-Pay advisory vote.

Stockholder Engagement. We routinely engage with stockholders and, as appropriate, with proxy advisory firms, to better understand their perspective regarding executive compensation best practices and have incorporated many of these practices in our executive compensation programs.

Here s What We Don t Do

No Multi-Year Guarantees. We do not offer multi-year guarantees for salary increases, bonuses or equity awards.

No Overly Generous Change in Control Benefits. We have used change in control protections sparingly and have limited cash payments to 1.5 to 3.0 times base salary and bonus.

No Gross-Ups. We do not provide tax gross ups for benefits that may become payable in connection with a change in control.

Limited Pension Benefits. We do not maintain a defined benefit pension plan or a supplemental executive retirement plan. The Company s 401(k) savings plan is its only pension benefit.

No Retirement Benefits. We do not offer retirement health and welfare benefits to our employees.

No Excessive Perquisites. We do not provide executives with perquisites such as financial planning, corporate aircraft, etc.

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STOCK OWNERSHIP

Security Ownership of Certain Beneficial Owners and Management

The following table sets forth certain information regarding the beneficial ownership of Veeco common stock as of March 12, 2018 (unless otherwise specified below) by (i) each person known by Veeco to own beneficially more than five percent of the outstanding shares of Veeco common stock, (ii) each director of Veeco, (iii) each NEO, and (iv) all executive officers and directors of Veeco as a group. Unless otherwise indicated, Veeco believes that each of the persons or entities named in the table exercises sole voting and investment power over the shares of Veeco common stock that each of them beneficially owns, subject to community property laws where applicable.

		Shares of Common Stock Beneficially Owned (1)		
	Shares	**Options**	**Total**	**Percentage of Total Shares Outstanding (1)**
5% or Greater Stockholders:				
BlackRock, Inc. (2)	6,683,401		6,683,401	13.9%
The Vanguard Group (3)	4,633,758		4,633,758	9.6%
Dimensional Fund Advisors LP (4)	2,962,158		2,962,158	6.2%
Frontier Capital Management Co., LLC (5)	2,614,375		2,614,375	5.4%
Directors:				
Kathleen A. Bayless	10,585		10,585	*
Richard A. D Amore	95,290		95,290	*
Gordon Hunter	28,949		28,949	*
Keith D. Jackson	25,149		25,149	*
John R. Peeler	371,436	282,610	654,046	1.4%
Peter J. Simone	24,332		24,332	*
Thomas St. Dennis	10,597		10,597	*
Named Executive Officers:				
John R. Peeler	371,436	282,610	654,046	1.4%
William J. Miller, Ph.D.	97,542	117,310	214,852	*
Shubham Maheshwari	72,887	54,000	126,887	*
John Kiernan	32,079	49,854	81,933	*
All Directors and Executive Officers as a Group (10 persons)	776,793	503,774	1,272,620	2.6%

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* Less than 1%.

(1) A person is deemed to be the beneficial owner of securities owned or which can be acquired by such person within 60 days of the measurement date upon the exercise of stock options. Shares owned include unvested restricted stock awards (but do not include unvested restricted stock units). Each person s percentage ownership is determined by assuming that stock options beneficially owned by such person (but not those owned by any other person) have been exercised.

(2) Share ownership information is based on information contained in a Schedule 13G/A filed with the SEC on February 8, 2018. The address of this holder is 55 East 52nd Street, New York, New York 10055.

(3) Share ownership information is based on information contained in a Schedule 13G/A filed with the SEC on February 9, 2018. The address of this holder is 100 Vanguard Boulevard, Malvern, Pennsylvania 19355.

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(4) Share ownership information is based on information contained in a Schedule 13G/A filed with the SEC on February 9, 2018. The address of this holder is Building One, 6300 Bee Cave Road, Austin, Texas 78746.

(5) Share ownership information is based on information contained in a Schedule 13G/A filed with the SEC on February 7, 2018. The address of this holder is 99 Summer Street, Boston, Massachusetts 02110.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act) requires Veeco s officers and directors, and persons who own more than 10% of Veeco s common stock, to file reports of ownership and changes in ownership with the Securities and Exchange Commission (SEC). These persons are required by SEC regulations to furnish Veeco with copies of all Section 16(a) forms they file. SEC regulations require us to identify in this proxy statement anyone who filed a required report late or failed to file a required report. Based on our review of forms we received, or written representations from reporting persons, we believe that during 2017 all Section 16(a) filing requirements were satisfied on a timely basis.

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GOVERNANCE

Governance Highlights

Veeco s Board of Directors and management are committed to responsible corporate governance to ensure that Veeco is managed for the long-term benefit of its stockholders. To that end, the Board of Directors and management review published guidelines and recommendations of institutional stockholder organizations and current best practices of similarly situated public companies. The Board and management periodically evaluate and, when appropriate, revise Veeco s corporate governance policies and practices in light of these guidelines and other findings, and to comply with the requirements of the Sarbanes-Oxley Act of 2002 and the rules and listing standards issued by the SEC and by The NASDAQ Stock Market LLC (NASDAQ).

Veeco s Corporate Governance Guidelines provide that at least two-thirds of the Board of Directors must be independent in accordance with the NASDAQ listing standards. In fact, 85.7% of Veeco s seven continuing directors and nominees are independent, and none serve on more than two other public company boards. All of Veeco s directors attended each Board meeting held in 2017, and at least 75% of applicable committee meetings. Veeco undergoes an annual Board, committee and individual director self-evaluation process, and the independent directors, guided by the independent Lead Director, meet regularly without management and perform an annual performance assessment of the Chief Executive Officer.

Governance Policies and Practices

Veeco has instituted a variety of policies and practices to foster and maintain corporate governance, including the following:

Corporate Governance Guidelines - Veeco adheres to written Corporate Governance Guidelines, adopted by the Board and reviewed by the Governance Committee from time to time. The Corporate Governance Guidelines govern director qualifications, conflicts of interest, succession planning, periodic board self-assessment and other governance matters. The Board has used an outside governance advisor to facilitate the board self-assessment at least every three years.

Code of Business Conduct - Veeco maintains written standards of business conduct applicable to all of its employees worldwide.

Code of Ethics for Senior Officers - Veeco maintains a Code of Ethics that applies to its Chief Executive Officer, President, Chief Financial Officer and Chief Accounting Officer.

Environmental, Health & Safety Policy - Veeco maintains a written policy that applies to all of its employees with regard to environmental, health and safety matters.

Director Education Policy - Veeco has adopted a written policy under which it encourages directors to attend, and provides reimbursement for the cost of attending, director education programs. A majority of Veeco s Board members has attended one or more director education programs within the past five years.

Disclosure Policy - Veeco maintains a written policy that applies to all of its employees with regard to the dissemination of information.

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Board Committee Charters **-** Each of Veeco s Audit, Compensation, Governance and Strategic Planning Committees has a written charter adopted by Veeco s Board that establishes practices and procedures for each committee in accordance with applicable corporate governance rules and regulations.

Copies of each of these documents can be found on the Company s website (www.veeco.com) via the Investors page.

Independence of the Board

Veeco s Corporate Governance Guidelines provide that at least two-thirds of the Board of Directors must be independent in accordance with the NASDAQ listing standards. In addition, service on other boards must be consistent with Veeco s conflict of interest policy and the nature and time involved in such service is reviewed when evaluating suitability of individual directors for election.

Independence of Current Directors. Veeco s Board of Directors has determined that all of the directors are independent within the meaning of the applicable NASDAQ listing standards, except Mr. Peeler, the Company s Chairman and Chief Executive Officer.

Independence of Committee Members. All members of Veeco s Audit, Compensation and Governance Committees are required to be and are independent in accordance with NASDAQ listing standards.

Compensation Committee Interlocks and Insider Participation. During 2017, none of Veeco s executive officers served on the board of directors of any entity whose executive officers served on Veeco s Compensation Committee. No current or past executive officer of Veeco serves on our Compensation Committee. The members of our Compensation Committee are Messrs. D Amore, Hunter and St. Dennis.

Board Access to Independent Advisors. The Board members have full and free access to the officers and employees of Veeco and are permitted to retain independent legal, financial or other advisors as the Board or a Committee deems necessary.

Director Resignation Upon Change in Employment. The Corporate Governance Guidelines provide that a director shall submit his resignation if he changes his principal employment, from what it was when he was elected as a director, or undergoes a change affecting his qualification as a director or fails to receive the required number of votes for re-election. Upon such submission, the Board shall determine whether to accept or reject the resignation. If the resignation is tendered for failure to receive the required number of votes for re-election, the Governance Committee will also inform the Board of any other action it recommends be taken.

Board Leadership Structure

Mr. Peeler, the Company s Chief Executive Officer, also serves as Chairman of the Board. We have a separate, independent Lead Director. Although we do not have a formal policy addressing the topic, we believe that when the Chairman of the Board is an employee of the Company or otherwise not independent, it is important to have a separate Lead Director, who is an independent director.

Mr. D Amore serves as the Lead Director. In that role, he presides over the Board s executive sessions, during which our independent directors meet without management, and he serves as the principle liaison between management and the independent directors of the Board. The Lead Director also:

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- Confers with the Chairman of the Board regarding Board meeting agendas;
- Has the authority to call meetings of the independent directors;
- Chairs meetings of the independent directors including, where appropriate, setting the agenda and briefing the Chairman of the Board on issues discussed during the meeting;
- Oversees the annual performance evaluation of the CEO;
- Consults with the Governance Committee and the Chairman of the Board regarding assignment of Board members to various committees; and
- Performs such other functions as the Board may require.

Mr. D Amore has served as Lead Director since 2016.

We believe the combination of Mr. Peeler as our Chairman of the Board and an independent director as our Lead Director is an effective structure for the Company. The division of duties and the additional avenues of communication between the Board and our management associated with this structure provide the basis for the proper functioning of our Board and its oversight of management.

Oversight of Risk Management

The Board has an active role, as a whole and also at the committee level, in overseeing management of the Company s risks. The Board regularly reviews information regarding the Company s strategy, finances and operations, as well as the risks associated with each. The Audit Committee is responsible for oversight of Company risks relating to accounting matters, financial reporting, internal controls and legal and regulatory compliance. The Audit Committee undertakes, at least annually, a review to evaluate these risks. Individual members of the Audit Committee are each assigned an area of risk to oversee. The members then meet separately with management responsible for such area, including the Company s chief accounting officer, internal auditor and general counsel, and report to the Audit Committee on any matters identified during such discussions with management. In addition, the Governance Committee manages risks associated with the independence of the Board and potential conflicts of interest. The Company s Compensation Committee is responsible for overseeing the management of risks relating to the Company s executive compensation plans and arrangements. While each committee is responsible for evaluating certain risks and overseeing the management of such risks, the entire Board is regularly informed about such risks through committee reports.

Compensation Risk

Our Compensation Committee conducted a risk-assessment of our compensation programs and practices and concluded that our compensation programs and practices, as a whole, are appropriately structured and do not pose a material risk to the Company. Our compensation programs are intended to reward the management team and other employees for strong performance over the long-term, with consideration of near-term actions and results that strengthen and grow our Company. We believe our compensation programs provide the appropriate balance between short-term and long-term incentives, focusing on sustainable operating success for the Company. We consider the potential risks in our business when designing and administering our compensation programs, and we believe our balanced approach to performance measurement and compensation decisions mitigates the likelihood that individuals will be encouraged to undertake excessive or inappropriate risk. Further, our compensation program administration is subject to considerable internal controls and when determining the principal outcomes performance assessments and compensation decisions we rely on principles of sound governance and good business judgment.

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Board Meetings and Committees

During 2017, Veeco s Board held eight meetings. It is the policy of the Board to hold executive sessions without management at every regularly scheduled board meeting and as requested by a director. The Lead Director or Committee Chairperson, as appropriate, presides over these executive sessions. All members of the Board are welcome to attend the Annual Meeting of Stockholders. In 2017, Mr. Peeler was the only director who attended the Annual Meeting. The Board has established the following committees: an Audit Committee, a Compensation Committee, a Governance Committee and a Strategic Planning Committee.

Audit Committee. As defined in Section 3(a)(58)(A) of the Exchange Act, the Company established an Audit Committee which reviews the scope and results of the audit and other services provided by Veeco s independent registered public accounting firm. The Audit Committee consists of Ms. Bayless and Messrs. Jackson and Simone (Chairman). The Board has determined that all members of the Audit Committee are financially literate as that term is defined by NASDAQ and by applicable SEC rules. The Board has determined that each of Ms. Bayless and Messrs. Jackson and Simone is an audit committee financial expert as defined by applicable SEC rules. During 2017, the Audit Committee met five times.

Compensation Committee. The Compensation Committee sets the compensation levels of senior management and administers Veeco s equity compensation plans. All members of the Compensation Committee are non-employee directors (within the meaning of Rule 16b-3 of the Exchange Act), and outside directors (within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended). None of the members of the Compensation Committee has interlocking relationships as defined by the SEC. The Compensation Committee consists of Messrs. D Amore, St. Dennis and Hunter (Chairman). During 2017, the Compensation Committee met nine times.

Governance Committee. The Company s Governance Committee addresses Board organizational issues and develops and reviews corporate governance principles applicable to Veeco. In addition, the committee searches for persons qualified to serve on the Board of Directors and makes recommendations to the Board with respect thereto, as more fully described below. The Governance Committee is comprised entirely of independent directors, as defined by the NASDAQ listing standards, and currently consists of Messrs. Hunter, Simone and Jackson (Chairman). During 2017, the Governance Committee met four times.

Strategic Planning Committee. The Company s Strategic Planning Committee oversees the Company s strategic planning process. The Strategic Planning Committee consists of Messrs. D Amore, Hunter, Simone, St. Dennis and Peeler (Chairman). During 2017, strategic planning matters were addressed by the full Board and, as a result, the Strategic Planning Committee did not meet in 2017.

Board Composition and Nomination Process

Pursuant to our Corporate Governance Guidelines, the Governance Committee will evaluate the suitability of potential nominees for membership on the Board, taking into consideration the Board s current composition, including expertise, diversity and balance of inside, outside and independent directors, and considering the general qualifications of the potential nominees, including those characteristics described in the Corporate Governance Guidelines as in effect from time to time. In selecting the director nominees, the Board endeavors to establish a diversity of background and experience in a number of areas of core competency, including business judgment, management, accounting and finance, knowledge of the industries in which the Company operates, understanding of manufacturing and services, strategic vision,

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knowledge of international markets, marketing, research and development and other areas relevant to the Company s business. Under our Corporate Governance Guidelines, the Board periodically conducts a critical self-evaluation, including an assessment of the make-up of the Board as a whole. In any particular situation, the Governance Committee may focus on persons possessing a particular background, experience or qualifications which the committee believes would be important to enhance the effectiveness of the Board. The full Board reviews and has final approval authority on all potential director candidates being recommended to the stockholders for election.

Compensation of Directors

As of January 1, 2017, Veeco s Director Compensation Policy provided that members of the Board of Directors who are not employees of Veeco shall be paid quarterly retainers as follows: for service as a Board member, $17,500; as chair of the Audit Committee, $5,000; as chair of the Compensation Committee, $3,750; as chair of the Governance Committee, $2,500; as chair of the Strategic Planning Committee, $2,500; and as Lead Director, $4,250. Changes to Veeco s Director Compensation Policy were approved by the Board at a meeting held on August 1, 2017. In particular, effective as of October 1, 2017: (i) the quarterly retainer for service as Lead Director increased to $5,125, and (ii) quarterly retainers are now paid for certain non-chair committee membership, specifically in the amount of $2,500 for Audit Committee membership, $1,875 for Compensation Committee membership, and $1,250 for Governance Committee membership. Board members do not receive fees for attending meetings either in person or telephonically.

Each non-employee Director shall also receive an annual grant of shares of restricted stock having a fair market value in the amount determined by the Compensation Committee from time to time. For 2017, the Compensation Committee determined that the value of this annual award should be $120,000 per director. The restrictions on these shares lapse on the earlier of the first anniversary of the date of grant and the date immediately preceding the date of the next annual meeting of stockholders. In addition, the Company s Director Compensation Policy in effect for 2017 gives the Board the authority to compensate directors who perform significant additional services on behalf of the Board or a Committee. Such compensation is to be determined by the Board in its discretion, taking into consideration the scope and extent of such additional services. Directors who are employees, such as Mr. Peeler, do not receive additional compensation for serving as directors.

The following table provides information on compensation awarded or paid to the non-employee directors of Veeco for the fiscal year ended December 31, 2017.

Name	Fees Earned or Paid in Cash ($)(1)	Stock Awards ($)(2)(3)	All Other Compensation ($)	Total ($)
Kathleen A. Bayless	72,500	119,973		192,473
Richard A. D Amore	89,750	119,973		209,723
Gordon Hunter	86,250	119,973		206,223
Keith D. Jackson	82,500	119,973		202,473
Peter J. Simone	91,250	119,973		211,223
Thomas St. Dennis	71,875	119,973		191,848

(1) Represents the sum of quarterly retainers paid for Board service during 2017.

(2) Reflects awards of 3,592 shares of restricted stock to each director on May 5, 2017. These restricted stock awards vest on the earlier of (i) the first anniversary of the date of grant, and (ii) the date immediately preceding the date of the next annual meeting of stockholders.

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In accordance with SEC rules, the amounts shown reflect the grant date fair value of the award, which was $33.40 per share.

(3) As of December 31, 2017, there were outstanding the following aggregate number of stock awards and option awards held by each non-employee director of the Company:

Outstanding Equity Awards at Fiscal Year End

Name	**Stock Awards (#)**	**Option Awards (#)**
Kathleen A. Bayless	3,592	
Richard A. D Amore	3,592	
Gordon Hunter	3,592	
Keith D. Jackson	3,592	
Peter J. Simone	3,592	
Thomas St. Dennis	3,592	

Stock Ownership Guidelines: Directors

Under the Company s Stock Ownership Guidelines, Directors are required to hold Veeco stock with a value equal to at least three times the Directors annual cash retainers (excluding retainers for committee or lead director service), measured as of February 1st of the most recently completed year and subject to a 5-year phase-in period.

Certain Contractual Arrangements with Directors and Executive Officers

Veeco has entered into indemnification agreements with each of its directors, executive officers and certain senior officers and anticipates that it will enter into similar agreements with any future directors and executive officers. Generally, the indemnification agreements are designed to provide the maximum protection permitted under Delaware law with respect to indemnification of a director or executive officer. The indemnification agreements provide that Veeco will indemnify such persons against certain liabilities that may arise by reason of their status or service as a director or executive officer of the Company and that the Company will advance expenses incurred as a result of proceedings against them as to which they may be indemnified. Under the indemnification agreements, a director or executive officer will receive indemnification if he or she is found to have acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of Veeco and with respect to any criminal action, if he or she had no reasonable cause to believe his or her conduct was unlawful.

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COMPENSATION

Executive Officers

The executive officers of Veeco, their ages and positions as of March 12, 2018, are as follows:

Name	Age	Position
John R. Peeler	63	Chairman and Chief Executive Officer
William J. Miller, Ph.D.	49	President
Shubham Maheshwari	46	Executive Vice President and Chief Financial Officer
John P. Kiernan	55	Senior Vice President, Finance, Chief Accounting Officer and Treasurer

John R. Peeler has been Chief Executive Officer and a Director of Veeco since July 2007, and Chairman since May 2012. Prior thereto, Mr. Peeler was Executive Vice President of JDS Uniphase Corp. (JDSU) and President of the Communications Test & Measurement Group of JDSU, which he joined upon the closing of JDSU s merger with Acterna in August 2005. Before joining JDSU, Mr. Peeler served as President and Chief Executive Officer of Acterna. Mr. Peeler joined a predecessor of Acterna in 1980 and served in a series of increasingly senior leadership roles including Vice President of Product Development, Executive Vice President and Chief Operating Officer, and President and CEO of TTC, a communications test equipment company. Mr. Peeler also serves on the board of IPG Photonics Corporation.

William J. Miller, Ph.D. has been President since January 2016, overseeing all of Veeco s global business units. Dr. Miller was named Executive Vice President, Process Equipment in December 2011, and was Executive Vice President, Compound Semiconductor from July 2010 until December 2011. Prior thereto, Dr. Miller was Senior Vice President and General Manager of Veeco s MOCVD business beginning in January 2009. From January 2006 to January 2009, Dr. Miller was Vice President, General Manager of Veeco s Data Storage equipment business. He held leadership positions of increasing responsibility in both the engineering and operations organizations since he joined Veeco in November 2002. Prior to joining Veeco, Dr. Miller held engineering and operations leadership positions at Advanced Energy Industries, Inc.

Shubham (Sam) Maheshwari has been Executive Vice President and Chief Financial Officer of Veeco since May 2014. Mr. Maheshwari oversees Veeco s Finance, Information Technology, Supply Chain and Global Manufacturing functions. From 2011 to 2014, Mr. Maheshwari served as Chief Financial Officer of OnCore Manufacturing LLC, a global manufacturer of electronic products in the medical, aerospace, defense and industrial markets. From 2009 to 2011, he held various finance roles including Senior Vice President Finance, Treasury, Tax and Investor Relations at Spansion, Inc., a global leader in flash memory based embedded system solutions. Mr. Maheshwari helped lead Spansion s emergence from bankruptcy to become a successful public company. From 1998 to 2009, he was with KLA-Tencor Corporation, a global semiconductor capital equipment manufacturing company, in various senior level corporate development and finance roles, including Vice President of Corporate Development and Corporate Controller. Mr. Maheshwari also serves on the board of Kateeva, Inc.

John P. Kiernan has been Senior Vice President, Finance, Chief Accounting Officer and Treasurer since December 2011, and also served as Corporate Controller from December 2011 through December 2017. From July 2005 to November 2011, Mr. Kiernan was Senior Vice President, Finance, Chief Accounting Officer and Corporate Controller. Prior thereto, he was Vice President, Finance and Corporate Controller of Veeco from April 2001 to June 2005, Vice President and Corporate Controller from November 1998 to March 2001, and Corporate Controller from February 1995 to November 1998. Prior to joining Veeco, Mr. Kiernan was an

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Audit Senior Manager at Ernst & Young LLP from October 1991 through January 1995 and held various audit staff positions with Ernst & Young LLP from June 1984 through September 1991.

Compensation Discussion and Analysis

Veeco develops, manufactures, sells, and supports semiconductor process equipment to meet the demands of key global trends, such as enhancing mobility, increasing connectivity, and improving energy efficiency. Our primary technologies include metal organic chemical vapor deposition (MOCVD), advanced packaging lithography, wet etch and clean, laser annealing, ion beam, molecular beam epitaxy, wafer inspection, and atomic layer deposition systems. These technologies play an integral role in producing light emitting diodes (LEDs) for solid-state lighting and displays, and in the fabrication and packaging of advanced semiconductor devices. We have sales and service operations across the Asia-Pacific region, Europe, and North America to address our customers needs.

We are focused on:

- Providing differentiated semiconductor process equipment to address customers current production requirements and next generation product development roadmaps;
- Investing to win through focused research and development in markets that we believe provide significant growth opportunities or are at an inflection point in semiconductor process equipment requirements, including LED, power electronics, photonics, front-end semiconductor, and advanced packaging technologies;
- Leveraging our sales channel and local process applications support teams to build strong strategic relationships with technology leaders;
- Expanding our services portfolio to improve the performance of our systems, including spare parts, upgrades, and consumables to drive growth, reduce our customers cost of ownership, and improve customer satisfaction;
- Cross-selling our product portfolio across our broad customer base and end markets to both maximize sales opportunities and diversify our business;
- Utilizing a combination of outsourced and internal manufacturing strategies to flex manufacturing capacity through industry investment cycles without compromising quality or performance; and

- Pursuing partnerships and acquisitions to expand our product portfolio into new and adjacent markets to drive sales growth.

Our products are sold to semiconductor and advanced packaging device manufacturers in the following four markets: Advanced Packaging, MEMS & RF Filters; LED Lighting, Display & Compound Semiconductor; Front-End Semiconductor; and Scientific & Industrial.

2017 Business Highlights

- We completed the acquisition of Ultratech, Inc. in May 2017. With the addition of Ultratech, we diversified our business, establishing ourselves as a leading equipment supplier in the advanced packaging market and greatly increasing our critical mass in the front-end semiconductor equipment market.

- We increased sales to $484.8 million, a 46% increase over 2016, driven in part by improvements in LED industry conditions and sales into the front-end semiconductor and advanced packaging markets.

- We achieved non-GAAP gross margins of 40.6%, delivering on our objective to realize gross margins of 40% or better.

- We increased non-GAAP Operating Income to $31.3 million, as compared to a loss of $8.5 million in 2016.

- We increased bookings to $571 million, an improvement of 53% over 2016.

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- We built our backlog to $334 million (the highest in 6 years), providing good first half 2018 visibility.

- We continued to strengthen our MOCVD product portfolio with the successful launch of the EPIK 868 MOCVD system, a higher productivity tool with a superior cost of ownership for our customers.

- We consolidated manufacturing in our New Jersey facility to improve efficiency and reduce costs.

- We announced a share repurchase program of up to $100 million to be completed over the next two years.

2017 Business Challenges

Despite the accomplishments and steps taken as described under 2017 Business Highlights above, our stock price performance has been disappointing. We attribute this, in part, to the highly-specialized, cyclical nature of our business, which is characterized by periods of significant volatility and is often difficult to predict. Also, during 2017, we faced three specific challenges, among others:

1. *Ultratech Cyclicality*. Following the Ultratech acquisition, orders from advanced packaging customers decreased, as customers delayed adoption of new technologies. We maintained our market share through this period but were negatively impacted by a down cycle in the advanced packaging lithography market.

2. *Increased Chinese Competition*. We saw the emergence of Chinese MOCVD competitors who benefitted from Chinese buy local sourcing initiatives and government incentives which allowed them to sell MOCVD equipment at significantly lower prices which, in turn, had a negative effect on Veeco s financial performance.

3. *Patent Disputes*. During 2017, we were engaged in intellectual property disputes with a Chinese competitor and a domestic supplier. These disputes were settled in February 2018 but were expensive and added uncertainty to our business.

Our executive compensation programs are designed to face these challenges, to align our costs with prevailing market conditions, to balance the short- and long-term interests of both stockholders and executives and, at the same time, retain and continue to attract executives throughout inherent downturns, motivating them for our longer term success.

The Company seeks to foster a performance-oriented culture by linking a significant portion of each executive s compensation to the achievement of performance targets important to the success of the Company and its stockholders. This Compensation Discussion and Analysis describes Veeco s current compensation programs and policies, which are subject to change.

We structure our executive compensation program each year so that a meaningful percentage of compensation is tied to the achievement of objectives that, at the time they are established, are considered challenging in light of the then anticipated market conditions.

Executive Compensation Strategy and Objectives

The Company s executive compensation strategy is designed to deliver competitive, performance-based total compensation that reflects our culture and the markets we serve. The primary objectives of Veeco s executive compensation programs are to attract, retain and motivate executives critical to the Company s long-term growth and success. The Company s executive compensation programs are designed to reward executives for increasing stockholder value without subjecting the Company or stockholders to unnecessary or unreasonable risks. The Company has adopted the following guiding principles:

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Performance-based: Compensation levels should be determined based on Company financial performance and individual results compared to quantitative and qualitative performance priorities set at the beginning of the performance period. Additionally, the ratio of performance-based compensation to fixed compensation should increase with the level of the executive, with the greatest amount of performance-based compensation at the CEO level. Performance-based compensation should be subject to a complete risk of forfeiture.

Stockholder-aligned: A significant portion of potential compensation should be performance- and equity-based to more closely align the interests of executives with those of our stockholders.

Fair and Competitive: Compensation levels should be fair, internally and externally, and competitive with overall compensation levels at other companies with which we compete for talent. Our compensation programs should promote our ability to both attract and retain our employees, including our executives.

Our target pay mix places significant emphasis on variable compensation comprised of performance-based restricted stock unit (PRSU) awards, time-based equity awards and an annual target bonus. As illustrated in the following charts, 71.9% and 68.5% of the target compensation packages for our CEO and our other named executive officers (NEOs), respectively, are comprised of equity-based and performance-based compensation. (Veeco s NEOs are identified in the Summary Compensation Table.)

CEO Compensation Elements

Other NEO Compensation Elements

Executive Compensation Governance and Procedures

The Compensation Committee (hereinafter in this Compensation Discussion and Analysis section, the Committee) administers the Company s compensation programs operating under a charter adopted by the Board. This charter authorizes the Committee to interpret the Company s compensation and equity plans and establish rules for their implementation and administration. The Committee consists of three independent directors who are appointed

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annually. The Committee works closely with the CEO and the Senior Vice President, Human Resources and relies on information provided by independent compensation consultants.

When making compensation decisions, the Committee considers the compensation practices and the competitive market for executives at companies with which we compete for talent. To this end, the Company utilizes a number of resources which, during 2017, included: meetings with Compensation Strategies, Inc., an independent compensation consultant; compensation surveys prepared by Radford; and executive compensation information compiled by Compensation Strategies, Inc. from the proxy statements of other companies, including a peer group.

Veeco s peer group (the Peer Group) reflects the companies that closely resemble Veeco based on industry and competition for talent. The Peer Group has been comprised of companies smaller than, similar to and larger than Veeco. In 2017, the Compensation Committee reviewed our Peer Group strategy and made changes to more closely align with Veeco s market segments and size as measured by revenue and market capitalization. This resulted in a 2017 Peer Group consisting of the following seventeen companies:

3D Systems Corporation*	MACOM Technology Solutions*
Advanced Energy Industries, Inc.	MKS Instruments, Inc.
Badger Meter, Inc.*	OSI Systems, Inc.*
Brooks Automation, Inc.	Photronics, Inc.*
Cabot Microelectronics Corporation*	Pure Storage, Inc.*
Cray Inc.*	Rudolph Technologies, Inc.
Entegris, Inc.*	Semtech Corporation*
FormFactor, Inc.*	Xperi Corporation (formerly Tessera Holding Corporation)*
Kulicke and Soffa Industries, Inc.	

*New member of the Peer Group following the Committee s 2017 review.

Applied Materials, Inc., Axcelis Technologies, Inc., Cohu, Inc., KLA Tencor Corporation, Lam Research Corporation, Nanometrics Incorporated, Newport Corporation, Teradyne, Inc., Ultratech, Inc., and Xcerra Corporation were removed from our Peer Group in 2017 as these companies were either no longer independent entities or did not align with Veeco s market segments and size as measured by revenue and market capitalization.

The Company considers the executive compensation practices of the companies in its Peer Group and the Radford survey (hereinafter collectively, the market data) as one of several factors used in setting compensation. The Company s compensation consultant uses statistical regression techniques to adjust market data to construct representative 50th-75th percentile market pay levels that are reflective of Veeco s size based on revenues. Although the Committee considers the executive compensation practices of the Peer Group companies and broader market data in setting compensation, it does not benchmark compensation to any specific percentile or ranking within our Peer Group. Individual compensation levels may vary within a range around market as a result of Veeco s financial and operating performance, personal performance, experience, and criticality, as well as competitive factors.

For 2017, total target compensation opportunities of Veeco s NEOs and other executives were generally reflective of the 50th percentile of market. Given the performance emphasis present in Veeco s executive compensation program, actual compensation earned or received can vary significantly with results; actual compensation for 2017 was below targeted opportunity levels.

In addition to reviewing the market data, the Committee meets with the Company s CEO and Senior Vice President, Human Resources to consider recommendations with respect to

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compensation for the NEOs and other executives. These recommendations include base salary levels, cash bonus targets and awards, and equity compensation awards. The Committee considers these recommendations along with other factors in determining specific compensation levels for the NEOs. The Committee discusses the elements of the CEO s compensation with him, but makes the final decisions regarding his compensation without him present.

Decisions regarding the Company s compensation program elements are made by the Committee in regularly scheduled and ad hoc meetings. Issues of significant importance are frequently discussed over several meetings. This practice provides the Committee with the opportunity to raise and address concerns before arriving at a decision. Prior to each meeting, the Committee is provided with the written materials, information and analyses as may be required to assist the Committee in its decision-making process. To the extent possible, meetings of the Committee are conducted in person. When this is not possible, meetings are conducted telephonically. The CEO and the Senior Vice President, Human Resources are regularly invited to attend Committee meetings but the Committee meets privately in executive sessions to consider certain matters including, but not limited to, the compensation of the CEO.

Elements of Our Executive Compensation Program

Our compensation programs are comprised of four elements: base salary, annual cash bonus, equity-based compensation and benefits and perquisites. Each of these elements is used to attract executives and reward them for performance results as described below:

Element	Description / Characteristics	Primary Objectives
Base Salary	• Annual cash compensation	• Attract and retain highly qualified talent
Annual Cash Incentive	• 100% performance-based cash compensation • Mix of annual financial and individual goals • Awards range from 0% to 200% of targets established for each executive	• Align executive compensation with annual goals important to the success of the Company • Promote a pay-for-performance culture
Equity-based Compensation	• Combination of time- and performance-based awards (performance-based comprising the majority) • Long-term (typically 3 4 years) stock-based compensation • PRSU awards granted with target performance period of 3 years	• Incentivize long-term performance • Serve as a retention incentive • Align the interests of executives with stockholders in the creation of long-term value • Foster a culture of stock ownership

	• PRSU awards earned based on financial metrics and subject to forfeiture	
Benefits & Perquisites	• Senior Executive Change in Control Policy • Company-subsidized health and welfare benefits • 401(k) savings plan	• Encourage executives to act in the best interests of stockholders • Promote productivity, remain competitive, and increase employee loyalty to the Company

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The Company evaluates each element of each executive s compensation individually and in the aggregate against market data for the position, experience, individual performance and the ability to affect future Company performance. The sections below describe the process for determining each of the four elements of the executive compensation program.

Base Salary

The Company pays base salaries to attract and retain executives. Base salaries are determined in accordance with the responsibilities of each executive, market data for the position and the executive s experience and individual performance. The Company considers each of these factors but does not assign a specific value to any one factor.

Base salaries for executives are typically set during the first half of the year in conjunction with the Company s annual performance management process. In 2017, following a review of the market data and management s recommendations, the Committee increased base salaries as follows:

Name		**April 2016**		**April 2017**	**Percent Increase**
J. Peeler	$	700,000	$	700,000	No Change(1)
W. Miller	$	460,000	$	474,000	3.0%
S. Maheshwari	$	430,000	$	443,000	3.0%
J. Kiernan	$	300,000	$	300,000	No Change

(1) Mr. Peeler s base salary has not been increased since April 2011.

Cash Bonus Plan

The Company provides the opportunity for cash bonuses under its annual bonus plan to attract executives and reward them for performance consistent with the belief that a significant portion of the compensation of its executives should be performance-based. As a result, individuals are compensated based on the achievement of specific financial and individual performance goals intended to correlate closely with stockholder value. The Company believes that the opportunity to earn cash bonuses motivates executives to meet Company performance objectives that, in turn, are linked to the creation of stockholder value. The Company utilizes profitability, as measured by adjusted operating income, as the financial element of its bonus plan. To help achieve our goal of retaining key talent, executives must generally be employees at the time awards are paid to be eligible to receive a bonus for that period.

On February 8, 2017, the Committee approved the 2017 Bonus Plan (the 2017 Plan) and the specific metrics thereof. Under the 2017 Plan, the bonus is based on the financial performance of the Company, as measured by adjusted operating income (Operating Income). We define Operating Income as earnings before the cost of bonuses, interest, taxes, and amortization, adjusted to exclude share-based compensation expense, one-time charges relating to restructuring initiatives, non-cash asset impairments, certain other non-operating gains and losses, and acquisition-related items such as one-time transaction costs and the stepped-up cost of goods sold associated with the purchase accounting of acquired inventory.

The Committee elected to use Operating Income as the 2017 Plan financial metric since it closely aligns operating performance to earnings per share, a key driver of shareholder value. If 2017 Operating Income is greater than $2 million (the threshold performance level), a bonus pool is funded with a fixed percentage of Operating Income. The bonus pool is not funded and bonus awards will not be earned if Operating Income results are less than the threshold performance level. The bonus pool would be fully funded and awards paid at 100% of target for Operating Income equal to $45.8 million. Awards to participants will be made from this fixed pool in accordance with their target bonus amounts. 25% of a participant s target bonus, after adjustment for Operating Income results, will be modified based on individual performance.

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Awards for individual performance will be paid from this fixed pool and may range from zero to 150%.

The total bonus award for an individual is capped at 200% of target bonus.

On May 26, 2017, the Company acquired Ultratech, Inc. Shortly thereafter, the Committee approved a proposal to exclude Ultratech operating income from the 2017 Plan financial results. However, following a review of year-end financial results, the Committee decided to include Ultratech results in the 2017 Plan financial results, which had the effect of reducing 2017 bonus awards as a result of losses incurred at Ultratech during 2017.

For 2017, Operating Income of $42.0 million exceeded the threshold and the bonus pool was funded at 91.6% of target, as follows:

Performance Level	Operating Income ($ million)		Award Percentage
Maximum	$	91.8	200%
Target	$	45.8	100%
Actual	$	42.0	91.6%
Threshold	$	2.0	26.6%

Under the 2017 Plan, 25% of the adjusted target may be adjusted based on individual performance measured against pre-established performance goals (the Individual Element), provided the minimum level of Operating Income required to fund the bonus is achieved. Actual awards for individual performance will be paid from a fixed pool, and may range from zero to 150% of the target for individual performance.

For the NEOs other than Mr. Peeler, actual awards for NEO individual performance were based on results compared to goals set by Mr. Peeler at the beginning of the year in connection with the Company s performance management process. The individual performance goals for these NEOs included functional objectives and individual objectives related to specific initiatives. The goals were not weighted and the award was considered on the totality of the individual performance results for each executive. After evaluation, Mr. Peeler made individual performance recommendations to the Committee for each of these NEOs, as set forth in the table below, reflecting the challenges faced during 2017.

Mr. Peeler s individual performance goals for 2017 were set by the Board at the beginning of the year and included: (1) increasing revenue versus a specific goal, (2) improving profitability versus a specific goal, (3) executing the Company s acquisition strategy, (4) developing the Company s organization and leadership, and (5) leading the Company through unexpected adversity and opportunity to maximize shareholder value. Following the plan year, it was determined that: (1) excluding acquisition results, revenue increased by 26%; (2) profit increased eleven-fold; (3) the Company completed the Ultratech acquisition in May 2017; (4) leaders in all of the Company s businesses and key functions are performing well; and (5) an intellectual property dispute with a Chinese competitor was successfully resolved. The Committee discussed Mr. Peeler s overall performance in executive session and awarded 50% ($92,173) (out of a maximum of 150%) of the value for the Individual Element of his bonus in recognition of his strong leadership during this challenging year but acknowledging, nonetheless, disappointment in the stock price.

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Messrs. Peeler, Maheshwari and Kiernan and Dr. Miller earned 2017 Plan awards as follows:

Name	**&nbttom: 1pt">**	Total Financing Receivables	Non-Accrual Loans[1]					
Real Estate:								
1-4 Family residential construction		$ 1,558	$ -	$ -	$ 1,558	$ 5,454	$ 7,012	$ 1,558
Other construction/Land		689	-	572	1,261	33,683	34,944	1,349
1-4 Family - closed-end		1,294	173	1,466	2,933	98,667	101,600	5,590
Equity Lines		24	290	66	380	61,512	61,892	732
Multi-family residential		-	-	-	-	5,201	5,201	-
Commercial real estate - owner occupied		594	734	1,845	3,173	171,994	175,167	6,409
Commercial real estate - non-owner occupied		-	22	711	733	91,082	91,815	5,193
Farmland		232	-	-	232	61,702	61,934	1,943
Total Real Estate		4,391	1,219	4,660	10,270	529,295	539,565	22,774
Agricultural		162	-	-	162	20,807	20,969	999
Commercial and Industrial		1,060	219	292	1,571	229,583	231,154	1,307
Small Business Administration		854	845	1,701	3,400	16,828	20,228	2,331
Direct finance leases		38	-	190	228	4,515	4,743	190
Consumer loans		354	69	111	534	29,937	30,471	1,253
Total Gross Loans and Leases		$ 6,859	$ 2,352	$ 6,954	$ 16,165	$ 830,965	$ 847,130	$ 28,854

[1] Included in Total Financing Receivables

	December 31, 2011						
	30-59 Days	60-89 Days Past	90 Days Or More	Total Past	Current	Total Financing	Non-Accrual Loans[1]

	Past Due	Due	Past Due(2)	Due		Receivables	
Real Estate:							
1-4 Family residential construction	$-	$ -	$ -	$-	$8,488	$ 8,488	$ 2,244
Other construction/Land	1,354	-	1,417	2,771	37,289	40,060	4,083
1-4 Family - closed-end	1,777	1,835	1,661	5,273	99,680	104,953	7,605
Equity Lines	253	511	640	1,404	65,093	66,497	1,309
Multi-family residential	-	-	2,941	2,941	5,238	8,179	2,941
Commercial real estate - owner occupied	3,070	1,038	5,581	9,689	173,381	183,070	7,086
Commercial real estate - non-owner occupied	1,031	577	7,128	8,736	97,107	105,843	13,958
Farmland	6,436	-	188	6,624	53,518	60,142	6,919
Total Real Estate	13,921	3,961	19,556	37,438	539,794	577,232	46,145
Agricultural	-	-	-	-	17,078	17,078	-
Commercial and Industrial	701	386	3,160	4,247	95,161	99,408	3,778
Small Business Administration	828	917	2,715	4,460	16,546	21,006	3,452
Direct finance leases	63	-	591	654	6,089	6,743	591
Consumer loans	520	619	838	1,977	34,147	36,124	2,144
Total Gross Loans and Leases	$16,033	$ 5,883	$ 26,860	$48,776	$708,815	$ 757,591	$ 56,110

(1) Included in Total Financing Receivables

(2) Includes Small Business Administration loans over 90 days past due and still accruing in the amount of $48,000.

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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, 2012, the Company had a total of $50.7 million in TDR’s, including $13.8 million in TDR’s that were on non-accrual status. Generally, a non-accrual loan that has been modified as a TDR remains on non-accrual status for a period of at least six months to demonstrate the borrower’s ability to comply with the modified terms. However, performance prior to the modification, or significant events that coincide with the modification, could result in a loan’s return to accrual status after a shorter performance period or even at the time of loan modification. TDR’s may have the TDR designation removed 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. Regardless of the period of time that has elapsed, if the borrower’s ability to meet the revised payment schedule is uncertain then the loan will be kept on non-accrual status. Moreover, a TDR is generally considered to be in default when it appears that the customer will not likely be able to repay all principal and interest pursuant to the terms of the restructured agreement.

The Company may agree to different types of concessions when modifying a loan or lease. The tables below summarize TDR’s which were modified during the noted periods, by type of concession:

Troubled Debt Restructurings, by Type of Loan Modification

(dollars in thousands, unaudited)

	For the Nine Months Ended September 30, 2012							
	Rate Modification	Term Modification	Interest Only Modification	Rate & Term Modification	Rate & Interest Only Modification	Term & Interest Only Modification	Rate, Term & Interest Only Modification	Total
Trouble Debt Restructurings								
Real Estate:								
Other construction/Land	$ -	$ 158	$ -	$ 309	$ -	$ -	$ -	$ 467
1-4 family - closed-end	-	228	-	41	-	222	-	491
Equity Lines	-	29	-	-	-	-	-	29
Commercial real estate - owner occupied	-	2,305	-	1,184	-	-	-	3,489
Commercial real estate - non owner occupied	-	328	-	60	-	-	-	388
Total Real Estate Loans	-	3,048	-	1,594	-	222	-	4,864
Agricultural Products	-	-	-	-	-	-	-	-
Commercial and Industrial	-	251	-	531	-	-	-	782
Consumer loans	-	1,042	-	225	-	-	47	1,314

Small Business Administration Loans	-	200	-	475	-	-	-	675
	$-	$ 4,541	$ -	$ 2,825	$ -	$ 222	$ 47	$7,635

For the Year Ended December 31, 2011

	Rate Modification	Term Modification	Interest Only Modification	Rate & Term Modification	Rate & Interest Only Modification	Term & Interest Only Modification	Rate, Term & Interest Only Modification	Total
Trouble Debt Restructurings								
Real Estate:								
Other construction/Land	$-	$ 555	$ -	$ 754	$ -	$ 6,188	$ -	$7,497
1-4 family - closed-end	-	6,419	-	151	561	48	421	7,600
Equity Lines	-	71	426	-	78	-	-	575
Commercial real estate - owner occupied	-	1,893	1,231	297	542	-	-	3,963
Commercial real estate - non owner occupied	7,400	-	-	1,069	6,420	-	-	14,889
Total Real Estate Loans	7,400	8,938	1,657	2,271	7,601	6,236	421	34,524
Agricultural Products	-	-	-	-	-	-	12	12
Commercial and Industrial	19	342	23	1,188	-	384	-	1,956
Consumer loans	278	495	-	2,069	282	-	85	3,209
Small Business Administration Loans	-	621	106	46	-	-	-	773
	$7,697	$ 10,396	$ 1,786	$ 5,574	$ 7,883	$ 6,620	$ 518	$40,474

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The following tables present, by class, additional details related to loans classified as TDR's during the three-month and nine-month periods ended September 30, 2012, including the recorded investment in the loan both before and after modification and balances that were modified during those periods:

Troubled Debt Restructurings
(dollars in thousands, unaudited)

	For the Three Months Ended September 30, 2012				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference[1]	Reserve
Real Estate:					
Other Construction/Land	4	$ 361	$ 355	$ (153)	$ 9
1-4 family - closed-end	2	159	159	(7)	11
Equity Lines	0	-	-	-	-
Commercial real estate- owner occupied	3	889	889	15	360
Commercial real estate- non-owner occupied	1	60	60	-	1
Total Real Estate Loans		1,469	1,463	(145)	381
Agricultural products	0	-	-	-	-
Commercial and Industrial	7	389	382	(80)	7
Consumer loans	13	459	455	41	62
Small Business Administration Loans	1	200	200	6	50
		$ 2,517	$ 2,500	$ (178)	$ 500

[1] This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

	For the Nine Months Ended September 30, 2012				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference[1]	Reserve
Real Estate:					
Other Construction/Land	6	$ 472	$ 467	$ (143)	$ 20
1-4 family - closed-end	5	503	491	20	57
Equity Lines	1	29	29	13	29
Commercial real estate- owner occupied	6	3,489	3,489	(57)	411
Commercial real estate- non-owner occupied	3	390	388	(45)	8
Total Real Estate Loans		4,883	4,864	(212)	525

Agricultural products	0	-	-	-	-
Commercial and Industrial	14	796	782	(107)	79
Consumer loans	27	1,320	1,314	(167)	207
Small Business Administration Loans	2	668	675	8	169
		$ 7,667	$ 7,635	$ (478)	$ 980

(1) This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

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The table below summarizes TDR's that defaulted during the period noted, and any charge-offs on those TDR's resulting from such default.

Troubled Debt Restructurings[(1)]
(dollars in thousands, unaudited)

	Subsequent default three months ended September 30, 2012		
	Number of Loans	Recorded Investment	Charge-Offs
Real Estate:			
Other Construction/Land	0	$ -	$ -
1-4 family - closed-end	1	222	-
Equity Lines	0	-	-
Commercial real estate- owner occupied	1	332	-
Commercial real estate- non owner occupied	0	-	-
Total Real Estate Loans		554	-
Agricultural products	0	-	-
Commercial and Industrial	1	66	66
Consumer Loans	0	-	-
Small Business Administration Loans	0	-	-
		$ 620	$ 66

	Subsequent default nine months ended September 30, 2012		
	Number of Loans	Recorded Investment	Charge-Offs
Real Estate:			
Other Construction/Land	0	$ -	$ -
1-4 family - closed-end	1	222	-
Equity Lines	0	-	-
Commercial real estate- owner occupied	1	332	-
Commercial real estate- non owner occupied	0	-	-
Total Real Estate Loans		554	-
Agricultural products	0	-	-
Commercial and Industrial	2	175	175
Consumer Loans	0	-	-
Small Business Administration Loans	0	-	-
		$ 729	$ 175

(1) Troubled Debt Restructurings within the previous 12 months for which there was a payment default in the periods noted.

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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. It is maintained at a level that is considered adequate to absorb probable losses on certain specifically identified loans, as well as probable incurred losses inherent in the remaining loan portfolio. 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 at least quarterly. 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. Included in the valuation allowance for impaired loans shown in the tables below are specific reserves allocated to TDR's, totaling $3.131 million at September 30, 2012 and $3.635 million at December 31, 2011.

Impaired Loans	September 30, 2012				
(dollars in thousands, unaudited)	Unpaid Principal Balance(1)	Recorded Investment(2)	Related Allowance	Average Recorded Investment	Interest Income Recognized(3)
With an Allowance Recorded					
Real Estate:					
1-4 family residential construction	$-	$ -	$ -	$ -	$ -
Other Construction/Land	1,432	1,432	435	1,451	24
1-4 Family - closed-end	10,197	10,197	1,150	10,236	256
Equity Lines	1,087	1,087	483	1,089	7
Multifamily residential	-	-	-	-	-
Commercial real estate- owner occupied	3,452	3,451	628	3,475	74
Commercial real estate- non-owner occupied	6,882	6,883	545	7,380	241
Farmland	91	91	3	95	-
Total Real Estate	23,141	23,141	3,244	23,726	602
Agricultural	1,363	999	2	945	-
Commercial and Industrial	2,277	2,242	571	2,334	35
Small Business Administration	2,559	2,559	768	2,559	37
Direct finance leases	190	190	92	190	-
Consumer loans	4,418	4,390	951	4,502	134
	33,948	33,521	5,628	34,256	808
With no Related Allowance Recorded					
Real Estate:					
1-4 family residential construction	$4,350	$ 1,558	$ -	$ 1,579	$ -
Other Construction/Land	7,510	6,857	-	6,894	244
1-4 Family - closed-end	9,423	9,132	-	9,178	87

Equity Lines	324	324	-	330	1
Multifamily residential	-	-	-	-	-
Commercial real estate- owner occupied	7,554	6,632	-	6,867	66
Commercial real estate- non-owner occupied	12,135	11,980	-	12,107	493
Farmland	1,852	1,852	-	1,861	-
Total Real Estate	43,148	38,335	-	38,816	891
Agricultural	-	-	-	-	-
Commercial and Industrial	-	-	-	-	-
Small Business Administration	863	863	-	863	-
Direct finance leases	-	-	-	-	-
Consumer loans	-	-	-	6	-
	44,011	39,198	-	39,685	891
Total	$77,959	$ 72,719	$ 5,628	$ 73,941	$ 1,699

(1)Contractual principal balance due from customer.

(2)Principal balance on Company's books, less any direct charge offs.

(3)Interest income is recognized on performing balances on a regular accrual basis.

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Impaired Loans	December 31, 2011				
(dollars in thousands, unaudited)	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Average Recorded Investment	Interest Income Recognized[3]
With an Allowance Recorded					
Real Estate:					
1-4 family residential construction	$188	$ 188	$ 13	$ 188	$ -
Other Construction/Land	3,477	2,906	735	2,925	89
1-4 Family - closed-end	8,086	8,057	821	8,071	222
Equity Lines	1,072	1,072	243	1,069	-
Multifamily residential	2,941	2,941	850	2,950	-
Commercial RE- owner occupied	3,628	3,628	834	3,645	24
Commercial RE- non-owner occupied	17,454	17,454	1,733	17,842	274
Farmland	-	-	-	-	-
Total Real Estate	36,846	36,246	5,229	36,690	609
Agriculture	-	-	-	-	-
Commercial and Industrial	4,135	4,106	1,481	4,197	24
Small Business Administration	3,902	3,903	1,212	3,903	2
Direct finance leases	591	591	291	591	-
Consumer loans	3,896	3,858	541	3,920	56
	49,370	48,704	8,754	49,301	691
With no Related Allowance Recorded					
Real Estate:					
1-4 family residential construction	$4,784	$ 2,056	$ -	$ 2,069	$ -
Other Construction/Land	11,740	9,081	-	9,326	193
1-4 Family - closed-end	12,467	12,203	-	12,250	101
Equity Lines	307	307	-	318	-
Multifamily residential	-	-	-	-	-
Commercial RE- owner occupied	6,049	6,030	-	6,136	17
Commercial RE- non-owner occupied	11,818	11,666	-	12,033	190
Farmland	7,468	6,919	-	6,956	-
Total Real Estate	54,633	48,262	-	49,088	501
Agriculture	-	-	-	-	-
Commercial and Industrial	916	915	-	965	11
Small Business Administration	-	-	-	-	-
Direct finance leases	-	-	-	-	-
Consumer loans	448	448	-	462	11
	55,997	49,625	-	50,515	523
Total	$105,367	$ 98,329	$ 8,754	$ 99,816	$ 1,214

(1)Contractual principal balance due from customer

(2)Principal balance on Company's books, less any direct charge offs.

(3)Interest income is recognized on performing balances on a regular accrual basis

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Similar but condensed information as of the dates noted is provided in the following table:

Impaired Loans
(dollars in thousands, unaudited)

	September 30, 2012	December 31, 2011
Impaired loans without a valuation allowance	$ 39,198	$ 49,625
Impaired loans with a valuation allowance	33,521	48,704
Total impaired loans [1]	$ 72,719	$ 98,329
Valuation allowance related to impaired loans	$ 5,628	$ 8,754
Total non-accrual loans	$ 28,854	$ 56,110
Total loans past-due ninety days or more and still accruing	$ -	$ 48

[1] Principal balance on Company's books less any direct charge-off

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 or operation of underlying collateral. Any change in impairment attributable to the passage of time is accommodated by adjusting the loss allowance accordingly.

For loans where repayment is expected to be provided by the disposition or operation of the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition where applicable, is less than the loan balance, then a specific loss reserve is established for the shortfall in collateral coverage. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is required. 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 83% of the Company's impaired real estate loan balances at September 30, 2012. 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 applicable. 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. 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, and current collateral values. 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 $7.2 million at September 30, 2012.

During the nine months ended September 30, 2012 we adjusted certain qualitative factors used in determining our allowance for loan and lease losses pursuant to our assessment that default risk in non-impaired loans is declining, and further refined the methodology for determining proxy loss rates that are incorporated into the model when there is insufficient data to utilize the Bank's own historical loan rates. Other than those adjustments, there have been no material changes implemented in 2012 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 tables that follow detail the activity in the allowance for loan and lease losses for the periods noted:

Allowance for Credit Losses and Recorded Investment in Financing Receivables

(dollars in thousands, unaudited)

	For the Three Months Ended September 30, 2012						
	Real Estate	Agricultural Products	Commercial and Industrial	Small Business Administration	Direct Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning Balance	$7,926	$ 18	$ 2,919	$ 1,165	$ 212	$ 1,623	$13,863
Charge-offs	(3,778)	(634)	(675)	(335)	-	(526)	(5,948)
Recoveries	33	-	70	35	-	53	191
Provision	2,423	629	550	79	(17)	1,036	4,700
Ending Balance	$6,604	$ 13	$ 2,864	$ 944	$ 195	$ 2,186	$12,806

	For the Nine Months Ended September 30, 2012						
	Real Estate	Agricultural Products	Commercial and Industrial	Small Business Administration	Direct Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning Balance	$8,260	$ 19	$ 4,638	$ 1,447	$ 311	$2,608	$17,283
Charge-offs	(9,179)	(634)	(3,215)	(753)	(198)	(1,873)	(15,852)
Recoveries	222	-	262	82	-	199	765
Provision	7,301	628	1,179	168	82	1,252	10,610
Ending Balance	$6,604	$ 13	$ 2,864	$ 944	$ 195	$2,186	$12,806
Reserves:							
Specific	$3,244	$ 2	$ 571	$ 768	$ 92	$951	$5,628
General	3,360	11	2,293	176	103	1,235	7,178
Ending Balance	$6,604	$ 13	$ 2,864	$ 944	$ 195	$2,186	$12,806
Loans evaluated for impairment:							
Individually	$61,476	$ 999	$ 2,242	$ 3,422	$ 190	$4,390	$72,719
Collectively	478,089	19,970	228,912	16,806	4,553	26,081	774,411
Ending Balance	$539,565	$ 20,969	$ 231,154	$ 20,228	$ 4,743	$30,471	$847,130

For the Year Ended December 31, 2011

	Real Estate	Agricultural Products	Commercial and Industrial	Small Business Administration	Direct Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning Balance	$10,143	$ 62	$ 6,379	$ 1,274	$ 284	$2,996	$21,138
Charge-offs	(10,596)	-	(3,407)	(148)	(82)	(2,754)	(16,987)
Recoveries	418	-	323	71	57	263	1,132
Provision	8,295	(43)	1,343	250	52	2,103	12,000
Ending Balance	$8,260	$ 19	$ 4,638	$ 1,447	$ 311	$2,608	$17,283
Reserves:							
Specific	$5,229	$ -	$ 1,481	$ 1,212	$ 291	$541	$8,754
General	3,031	19	3,157	235	20	2,067	8,529
Ending Balance	$8,260	$ 19	$ 4,638	$ 1,447	$ 311	$2,608	$17,283
Loans evaluated for impairment:							
Individually	$84,508	$ -	$ 5,021	$ 3,903	$ 591	$4,306	$98,329
Collectively	492,724	17,078	94,387	17,103	6,152	31,818	659,262
Ending Balance	$577,232	$ 17,078	$ 99,408	$ 21,006	$ 6,743	$36,124	$757,591

Note 13 – Recent Developments

On June 12, 2012, banking regulators issued a notice of proposed rulemaking outlining potential new regulatory capital guidelines which conform to Basel III requirements. While there is lingering uncertainty with regard to exemptions that might apply to community banks, if ultimately adopted as proposed the new rules would, among other things:

1) add a new regulatory capital component referred to as "common equity tier 1 capital", and establish threshold ratios for this new component (e.g., 6.5% to be "well-capitalized");
2) impose a new "capital conservation buffer" of at least 2.5% of risk-weighted assets to be added to common equity tier 1 capital, and limit dividend payments, share buybacks, and certain discretionary bonus payments to executive officers if the capital conservation buffer is not achieved;
3) provide a phase-out period for the inclusion of trust-preferred securities as tier 1 capital (although TRUPS would reportedly still be includible in tier 2 capital);
4) require us to include accumulated other comprehensive income (AOCI) in tier 1 capital, which could significantly increase capital volatility;
5) impose additional constraints on the inclusion of minority interests, mortgage servicing assets, and deferred tax assets in regulatory capital;
6) adjust risk-weightings for certain assets, such as the assignment of a risk weighting of 150% to certain acquisition/development and construction loans, a risk weighting of 150% for loans that are more than 90-days past due or are on non-accrual status, and risk weightings for residential mortgages based on loan-to-value ratios and certain other loan characteristics; and
7) increase minimum required ratios over a phase-in period, and increase the threshold for a "well-capitalized" classification for the Tier 1 Risk-Based Capital Ratio from 6% to 8%.

The largest impact on the consolidated Company would likely come from the exclusion of $30 million in TRUPS from tier 1 capital. Other potential changes that could materially affect us include the additional constraints on the inclusion of deferred tax assets in capital, increased risk weightings for nonperforming loans and acquisition/development loans, and the inclusion of accumulated other comprehensive income in regulatory capital. The inclusion of AOCI would benefit us as long as we have a net unrealized gain on securities, but would lower our regulatory capital ratios if interest rates increase and our unrealized gain becomes an unrealized loss.

The aggregate effect of these regulatory changes on Sierra Bancorp and Bank of the Sierra cannot yet be determined with any degree of certainty, but our preliminary estimates indicate that if the changes are implemented and when they become fully phased-in they could have a material impact on our Tier 1 Leverage Ratio and our consolidated Tier 1 Risk-Based Capital Ratio. Nevertheless, given our current level of capital we should be well-positioned to absorb the impact of Basel III without constraining our organic growth plans, although no assurance can be provided in that regard.

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. They include, but are not limited to, further 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; declines in the 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 as discussed in the "Other Assets" section of this discussion and analysis; 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 those areas.

OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

results of operations Summary

Third quarter 2012 compared to Third quarter 2011

Net income for the quarter ended September 30, 2012 was $1.635 million, representing a decline of $891,000, or 35%, relative to net income of $2.526 million for the quarter ended September 30, 2011. Basic and diluted earnings per share for the third quarter of 2012 were $0.12, compared to $0.18 basic and diluted earnings per share for the third quarter of 2011. The Company's annualized return on average equity was 3.74% and annualized return on average assets was 0.46% for the quarter ended September 30, 2012, compared to a return on equity of 6.00% and return on assets of 0.74% for the quarter ended September 30, 2011. The primary drivers behind the variance in third quarter net income are as follows:

- Net interest income was down $418,000, or 3%, due to a 29 basis point drop in the Company's net interest margin that was partially offset by a $44 million increase in average interest-earning assets. Factors contributing to the negative variance in the net interest margin include a shift from real estate and consumer loan balances into lower-yielding commercial loan balances, and lower loan yields resulting from increased competition for quality loans. However, those unfavorable factors were partially offset by a $15 million drop in the average balance of nonperforming loans, sizeable increases in the average balances of non-interest bearing demand deposits and equity, a shift in average interest-bearing deposit balances from higher-cost time deposits into lower-cost non-maturity deposits, and a drop in deposit rates due to the general lack of competitive pressures.

- The Company's loan loss provision was increased by $1.7 million, or 57%. The $4.7 million loan loss provision in the third quarter of 2012 was used to provide specific reserves for newly-impaired loans, replenish reserves subsequent to charge-offs, and establish general reserves for net growth in loan balances.

- Total non-interest revenue increased by $527,000, or 16%, due in large part to an increase in income on bank-owned life insurance (BOLI) associated with deferred compensation plans, which was partially offset by higher net losses on the sale of OREO in the third quarter of 2012.

- Total operating expense increased by $443,000, or 4%. The largest variances in operating expense include increases in deferred compensation accruals for officers and directors (related to the increase in BOLI income discussed above), lower marketing costs related to the timing of payments, a drop in expenses associated with OREO, higher regulatory assessments due to accrual adjustments made in the third quarter of 2011, an increase in fraud losses on debit cards, and lower occupancy costs resulting in part from the purchase of our headquarters office building in the fourth quarter of 2011.

- The Company had a tax benefit of $321,000 in the third quarter of 2012, relative to a tax provision of $822,000 in the third quarter of 2011 which was 25% of pre-tax income. The negative tax provisioning rate for the third quarter of 2012 is primarily the result of lower taxable income relative to the Company's available tax credits, and was impacted further by a sizeable increase in tax-exempt BOLI income for that quarter.

First Nine months 2012 compared to First Nine months 2011

Net income for the first nine months of 2012 was $6.087 million, representing a decline of $152,000, or 2%, relative to net income of $6.239 million for the first nine months of 2011. Basic and diluted earnings per share for the first nine months of 2012 were $0.43, compared to $0.45 basic earnings per share and $0.44 diluted earnings per share for the first nine months of 2011. The Company's annualized return on average equity was 4.73% and annualized return on average assets was 0.59% for the nine months ended September 30, 2012, compared to a return on equity of 5.09% and return on assets of 0.63% for the nine months ended September 30, 2011. The primary drivers behind the variance in year-to-date net income are as follows:

- Net interest income declined $1.855 million, or 5%, due to a 35 basis point drop in the Company's net interest margin partially offset by a $33 million increase in average interest-earning assets. Factors contributing to the negative variance in the net interest margin include a proportionately small increase in average loans relative to the increase in lower-yielding investments, a shift from real estate and consumer loan balances into lower-yielding commercial loan balances, and lower loan yields resulting from increased competition for quality loans. However, as with the quarterly comparison, those unfavorable factors were partially offset by a drop in the average balance of nonperforming loans, sizeable increases in the average balances of non-interest bearing demand deposits and equity, a shift in average interest-bearing deposit balances from higher-cost time deposits into lower-cost non-maturity deposits, and a drop in deposit rates due to the general lack of competitive pressures.

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- The Company's loan loss provision was increased by $1.010 million, or 11%. As with the quarter, the $10.610 million loan loss provision for the year-to-date period was used to provide specific reserves for newly-impaired loans, replenish reserves subsequent to charge-offs, and establish general reserves for net growth in loan balances.

- Total non-interest revenue increased by $1.803 million, or 17%, due in large measure to an increase in BOLI income associated with deferred compensation plans, and accrual adjustments which caused a drop in expenses associated with low-income housing tax credit investments and other limited partnerships (those expenses are accounted for as a reduction in income). Debit card interchange income was also up for the year-to-date comparison, and we had $161,000 in gains on the sale of investments during the first nine months of 2012. Another favorable variance came from risk-adjusted fees on certain deposits accounts which were implemented in the fourth quarter of 2011, although that increase was offset to a great extent by a drop in fee income on returned item and overdraft charges.

- Total operating expense declined by $190,000, or 1%. Favorable variances in operating expense include lower marketing costs related to the timing of payments, a drop in occupancy expense, lower regulatory assessments, and declining OREO costs. Unfavorable variances include higher deferred compensation accruals for officers and directors (related to the increase in BOLI income discussed above), higher data processing costs due to $181,000 in non-recurring vendor credits received in the first quarter of 2011, higher telecommunications expense, and higher debit card losses caused by a surge in fraud-related incidents in the third quarter of 2012.

- Because of the tax benefit recorded in the third quarter of 2012, the Company's provision for income taxes dropped for the year-to-date period to only $54,000, or less than 1% of pre-tax income. The Company's tax provision was $774,000 for the first nine months of 2011, which equates to 11% of pre-tax income.

Financial Condition Summary

September 30, 2012 relative to December 31, 2011

The most significant characteristics of, and changes in, the Company's balance sheet during the first nine months of 2012 are outlined below:

- The Company's assets totaled $1.423 billion at September 30, 2012, an increase of $88 million, or 7%, relative to total assets of $1.335 billion at December 31, 2011. Total assets increased due mainly to growth in loans, comprised primarily of an increase in balances outstanding on mortgage warehouse lines that was partially offset by a $27 million drop in nonperforming loans.

- Total nonperforming assets fell by $23 million, or 32%, to $49 million at September 30, 2012 from $71 million at December 31, 2011. In addition to nonperforming assets, the Company had $37 million in performing troubled debt restructurings (TDR's) as of September 30, 2012, a slight increase relative to year-end 2011.

The Company's allowance for loan and lease losses was $12.8 million as of September 30, 2012, a decline of over $4 million, or 26%, relative to year-end 2011. The drop was due to write-downs on certain impaired collateral-dependent loans against previously-established specific reserves, which did not directly lead to the need for reserve replenishment, as well as a reduction in general reserves consistent with the Company's improvement in asset quality. Net loans charged off against the allowance totaled $15.087 million in the first nine months of 2012 relative to net charge-offs of $10.246 million in the first nine months of 2011. Because of the decline in the overall allowance and the increase in total loans, the allowance fell to 1.51% of total loans at September 30, 2012 from 2.28% at December 31, 2011.

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- Total deposits increased by $60 million, or 5%. Core non-maturity deposits increased by $47 million, or 7%, including sizeable increases in non-interest bearing demand deposits, interest-bearing transaction accounts, and savings deposits. The only non-maturity deposit category that declined was money market deposits, which were down $4 million, or 5%, for the first nine months of 2012. Customer time deposits, including reciprocal deposits obtained via the Certificate of Deposit Account Registry Service (CDARS), increased by $12 million, or 4%.

- Despite strong growth in deposits, additional funding was obtained for loan growth via borrowings from the Federal Home Loan Bank, which increased by $21 million.

- Total capital increased by $6 million, or 4%, to $174 million at September 30, 2012, but risk-based capital ratios declined since capital was leveraged for organic loan growth. Our consolidated total risk-based capital ratio fell to 19.96% at September 30, 2012 from 21.72% at year-end 2011. Our tier one risk-based capital ratio was 18.70% and our tier one leverage ratio was 13.50% at September 30, 2012.

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 2012 relative to the third quarter of 2011 net interest income declined by $418,000, or 3%. For the year-to-date comparison, net interest income declined by $1.855 million, or 5%. 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 tables show the average balance of each significant balance sheet category, and the amount of interest income or interest expense associated with each applicable category, for the noted periods. The tables also display the calculated yields on each major component of the Company's investment and loan portfolios, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin.

Average Balances and Rates (dollars in thousands, except per share data)	For the Three Months Ended September 30, 2012				For the Three Months Ended September 30, 2011			
	Average Balance [1]	Income/ Expense	Average Rate/Yield [2][3]		Average Balance [1]	Income/ Expense	Average Rate/Yield [2][3]	
Assets								
Investments:								
Federal funds sold/Due from time	$22,858	$15	0.26	%	$35,763	$23	0.25	%
Taxable	335,979	1,513	1.76	%	340,428	2,420	2.78	%
Non-taxable	81,521	700	5.09	%	74,630	716	5.69	%
Equity	1,840	10	2.13	%	1,564	-	0.00	%
Total Investments	442,198	2,238	2.30	%	452,385	3,159	3.05	%
Loans and Leases:[4]								
Agricultural	17,905	232	5.15	%	14,455	162	4.45	%
Commercial	201,435	2,662	5.26	%	101,487	1,465	5.73	%
Real Estate	527,474	8,402	6.34	%	550,405	9,093	6.55	%
Consumer	30,239	605	7.96	%	38,658	971	9.97	%
Direct Financing Leases	3,983	53	5.29	%	6,240	89	5.66	%
Nonperforming Loans	32,926	-	0.00	%	48,267	-	0.00	%
Total Loans and Leases	813,962	11,954	5.84	%	759,512	11,780	6.15	%
Total Interest Earning Assets [5]	1,256,160	14,192	4.61	%	1,211,897	14,939	5.01	%
Other Earning Assets	6,389				7,528			
Non-Earning Assets	143,075				131,936			
Total Assets	$1,405,624				$1,351,361			
Liabilities and Shareholders' Equity								
Interest Bearing Deposits:								
Demand Deposits	$67,331	$60	0.35	%	$28,206	$58	0.82	%
NOW	194,628	123	0.25	%	181,317	203	0.44	%
Savings Accounts	109,070	61	0.22	%	88,388	53	0.24	%
Money Market	79,184	32	0.16	%	130,938	85	0.26	%
CDAR's	18,768	16	0.34	%	43,912	58	0.52	%
Certificates of Deposit<$100,000	112,412	157	0.56	%	136,079	244	0.71	%
Certificates of Deposit≥$100,000	225,905	297	0.52	%	207,012	311	0.60	%
Brokered Deposits	15,000	50	1.33	%	15,000	51	1.35	%
Total Interest Bearing Deposits	822,298	796	0.39	%	830,852	1,063	0.51	%
Borrowed Funds:								
Federal Funds Purchased	-	-	0.00	%	1	-	0.00	%
Repurchase Agreements	5,434	8	0.59	%	4,842	7	0.57	%
Short Term Borrowings	24,019	15	0.25	%	638	-	0.00	%
Long Term Borrowings	5,000	51	4.06	%	15,000	143	3.78	%
TRUPS	30,928	193	2.48	%	30,928	179	2.30	%
Total Borrowed Funds	65,381	267	1.62	%	51,409	329	2.54	%
Total Interest Bearing Liabilities	887,679	1,063	0.48	%	882,261	1,392	0.63	%
Non-interest Bearing Demand Deposits	327,368				285,114			
Other Liabilities	16,513				16,821			
Shareholders' Equity	174,064				167,165			

Total Liabilities and Shareholders' Equity	$1,405,624				$1,351,361			
Interest Income/Interest Earning Assets			4.61	%			5.01	%
Interest Expense/Interest Earning Assets			0.34	%			0.46	%
Net Interest Income and Margin(6)		$13,129	4.27	%		$13,547	4.56	%

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
(2) Yields and net interest margin have been computed on a tax equivalent basis utilizing a 34% effective tax rate.
(3) Annualized
(4) Loan costs have been included in the calculation of interest income. Loan costs were approximately $(81) thousand and $94 thousand for the quarters ended September 30, 2012 and 2011.
Loans are gross of the allowance for possible loan losses.

(5) Non-accrual loans have been included in total loans for purposes of total earning assets.
(6) Net interest margin represents net interest income as a percentage of average interest-earning assets.

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Average Balances and Rates (dollars in thousands, except per share data)	For the Nine Months Ended September 30, 2012			For the Nine Months Ended September 30, 2011		
	Average Balance (1)	Income/ Expense	Average Rate/Yield (2)(3)	Average Balance (1)	Income/ Expense	Average Rate/Yield (2)(3)
Assets						
Investments:						
Federal funds sold/Due from time	$26,694	$51	0.25 %	$29,447	$56	0.25 %
Taxable	339,873	5,116	1.98 %	310,225	6,621	2.81 %
Non-taxable	77,146	2,052	5.30 %	73,290	2,153	5.87 %
Equity	1,698	43	3.33 %	1,570	-	0.00 %
Total Investments	445,411	7,262	2.45 %	414,532	8,830	3.16 %
Loans and Leases:(4)						
Agricultural	15,985	547	4.57 %	13,485	493	4.89 %
Commercial	150,343	6,157	5.47 %	103,557	4,585	5.92 %
Real Estate	528,233	25,326	6.40 %	558,791	27,233	6.52 %
Consumer	31,674	2,042	8.61 %	41,237	2,861	9.28 %
Direct Financing Leases	4,416	179	5.41 %	7,096	308	5.80 %
Nonperforming Loans	44,744	-	0.00 %	48,813	-	0.00 %
Total Loans and Leases	775,395	34,251	5.90 %	772,979	35,480	6.14 %
Total Interest Earning Assets (5)	1,220,806	41,513	4.66 %	1,187,511	44,310	5.11 %
Other Earning Assets	6,650			7,916		
Non-Earning Assets	141,799			132,800		
Total Assets	$1,369,255			$1,328,227		
Liabilities and Shareholders' Equity						
Interest Bearing Deposits:						
Demand Deposits	$67,862	$190	0.37 %	$9,505	$58	0.82 %
NOW	193,977	457	0.31 %	178,029	623	0.47 %
Savings Accounts	104,793	178	0.23 %	83,391	148	0.24 %
Money Market	80,011	97	0.16 %	150,744	467	0.41 %
CDAR's	18,583	43	0.31 %	41,980	183	0.58 %
Certificates of Deposit<$100,000	105,548	482	0.61 %	151,758	790	0.70 %
Certificates of Deposit≥$100,000	224,064	892	0.53 %	198,446	884	0.60 %
Brokered Deposits	15,000	151	1.34 %	12,308	126	1.37 %
Total Interest Bearing Deposits	809,838	2,490	0.41 %	826,161	3,279	0.53 %
Borrowed Funds:						
Federal Funds Purchased	-	-	0.00 %	2	-	0.00 %
Repurchase Agreements	3,994	18	0.60 %	2,176	12	0.74 %
Short Term Borrowings	12,871	23	0.24 %	1,898	34	2.40 %
Long Term Borrowings	7,628	231	4.05 %	15,000	425	3.79 %
TRUPS	30,928	586	2.53 %	30,928	540	2.33 %
Total Borrowed Funds	55,421	858	2.07 %	50,004	1,011	2.70 %
Total Interest Bearing Liabilities	865,259	3,348	0.52 %	876,165	4,290	0.65 %
Non-interest Bearing Demand Deposits	314,804			272,296		
Other Liabilities	17,133			15,961		
Shareholders' Equity	172,059			163,805		

Total Liabilities and Shareholders' Equity	$1,369,255				$1,328,227		
Interest Income/Interest Earning Assets			4.66	%		5.11	%
Interest Expense/Interest Earning Assets			0.37	%		0.48	%
Net Interest Income and Margin[6]		$38,165	4.29	%	$40,020	4.64	%

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

(2) Yields and net interest margin have been computed on a tax equivalent basis utilizing a 34% effective tax rate.

(3) Annualized

(4) Loan costs have been included in the calculation of interest income. Loan costs were approximately $149 thousand and $432 thousand for the nine months ended September 30, 2012 and 2011.
Loans are gross of the allowance for possible loan losses.

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

(6) Net interest margin represents net interest income as a percentage of average interest-earning assets.

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

Volume & Rate Variances (dollars in thousands)	Three Months Ended September 30, 2012 over 2011 Increase(decrease) due to			Nine Months Ended September 30, 2012 over 2011 Increase(decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
Assets:						
Investments:						
Federal funds sold / Due from time	$ (8)	$ 0	$ (8)	$ (5)	$ 0	$ (5)
Taxable	(32)	(875)	(907)	633	(2,138)	(1,505)
Non-taxable[1]	66	(82)	(16)	113	(214)	(101)
Equity	-	10	10	-	43	43
Total Investments	26	(947)	(921)	741	(2,309)	(1,568)
Loans and Leases:						
Agricultural	39	31	70	91	(37)	54
Commercial	1,443	(246)	1,197	2,071	(499)	1,572
Real Estate	(379)	(312)	(691)	(1,489)	(418)	(1,907)
Consumer	(211)	(155)	(366)	(663)	(156)	(819)
Direct Financing Leases	(32)	(4)	(36)	(116)	(13)	(129)
Other	-	-	-	-	-	-
Total Loans and Leases	859	(685)	174	(106)	(1,123)	(1,229)
Total Interest Earning Assets	$ 885	$ (1,632)	$ (747)	$ 635	$ (3,432)	$ (2,797)
Liabilities						
Interest Bearing Deposits:						
Demand Deposits	$ 80	$ (78)	$ 2	$ 356	$ (224)	$ 132
NOW	15	(95)	(80)	56	(222)	(166)
Savings Accounts	12	(4)	8	38	(8)	30
Money Market	(34)	(19)	(53)	(219)	(151)	(370)
CDAR's	(33)	(9)	(42)	(102)	(38)	(140)
Certificates of Deposit < $100,000	(42)	(45)	(87)	(241)	(67)	(308)
Certificates of Deposit ≥ $100,000	28	(42)	(14)	114	(106)	8
Brokered Deposits	-	(1)	(1)	28	(3)	25
Total Interest Bearing Deposits	28	(295)	(267)	30	(819)	(789)
Borrowed Funds:						
Federal Funds Purchased	-	-	-	-	-	-
Repurchase Agreements	(0)	1	1	10	(4)	6
Short Term Borrowings	-	15	15	197	(208)	(11)
Long Term Borrowings	(95)	3	(92)	(209)	15	(194)
TRUPS	-	14	14	-	46	46
Total Borrowed Funds	(95)	33	(62)	(2)	(151)	(153)

Total Interest Bearing Liabilities	(69)	(260)	(329)	28	(970)	(942)
Net Interest Margin/Income	$ 954	$ (1,371)	$ (418)	$ 607	$ (2,462)	$ (1,855)

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

As shown above, the volume variance for the third quarter of 2012 relative to the third quarter of 2011 was a favorable $954,000, due primarily to growth of $44 million in average interest-earning assets. We experienced a net increase of $54 million in average loans, but the positive impact from loan growth was muted to some extent by the fact that it was generally concentrated in lower-yielding agricultural and commercial loans, while higher-yielding real estate loans and consumer loans declined. Also impacting the volume variance was a $10 million decline in the average balance of investments and a $15 million reduction in nonperforming loans. The shift from lower-yielding investments into loans and the reduction in nonperforming loans enhanced the positive impact of balance sheet growth on our volume variance for the quarter, as did favorable changes in average liability and equity balances. While average wholesale borrowings were $14 million higher, the increase was in relatively inexpensive overnight borrowings and the average balance of higher-cost term borrowings actually declined by $10 million. We also experienced migration out of aggregate time deposits into lower-cost non-maturity deposits for the comparative quarters, including a $42 million increase in the average balance of non-interest bearing demand deposits. A $7 million increase in average equity further reduced our reliance on interest-bearing liabilities.

In contrast to the favorable volume variance for the quarterly comparison, the impact of interest rate changes created a $1.371 million unfavorable rate variance in net interest income. Our weighted average yield on interest-earning assets was 40 basis points lower due to growth in lower-yielding loan categories, as well as a general decline in loan interest rates due to intense competition for quality loans. In addition to lower loan rates, our yield on investments fell by 75 basis points due to the reinvestment of cash from prepayments and maturing balances into lower-yielding investments, in a historically low rate environment. By comparison, our weighted average cost of interest-bearing liabilities was just 15 basis points lower, with the drop due primarily to the lack of competitive pressures on deposit rates and an improving deposit mix. The negative rate variance is exacerbated by our sizeable net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. Our average net interest position for the third quarter of 2011, which is the base period for the rate variance calculation, was $330 million, meaning that the yield decrease for interest-earning assets was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income. Helping offset some of the negative pressures on our rate variance for the quarterly comparison was the fact that we had $2,000 in net interest recoveries in the third quarter of 2012, relative to $215,000 in net interest reversals in the third quarter of 2011.

The Company’s net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.27% in the third quarter of 2012, a decline of 29 basis points relative to the third quarter of 2011. The principal negative factors impacting our net interest margin in the third quarter of 2012 include growth in lower-yielding loan balances and lower average balances for higher-yielding loan categories, as well as competitive pressures on loan yields. Developments favorably impacting our net interest margin include migration in average balances from higher-cost time deposits into lower-cost non-maturity deposits, increases in non-interest bearing demand deposits and equity that were sufficient to fund growth in earning assets, and the favorable differential in net interest recoveries/reversals.

For the first nine months of 2012 relative to the first nine months of 2011, the favorable variance in net interest income attributable purely to volume changes was $607,000, although there was a negative rate variance of $2.462 million. The volume variance for the year-to-date period was due to a $33 million increase in average interest-earning assets, and would have been more significant if not for the fact that the year-to-date results do not reflect the full impact of our recent loan growth. For the year-to-date comparison, average loan balances are up by only $2 million, while the average balance of lower-yielding investments is $31 million higher. Furthermore, the year-to-date comparison reflects a shift within loans from higher-yielding real estate and consumer loans into lower-yielding commercial and agricultural loans. As with the quarterly comparison, relatively strong growth in the average balances of low-cost customer deposits and equity helped compensate for some of the unfavorable pressures on the volume variance.

The same factors discussed for the quarterly rate variance were applicable with regard to the rate variance for the year-to-date period. For the first nine months of 2012 relative to the first nine months of 2011 the weighted average yield on earning assets was 45 basis points lower, while the weighted average cost of interest-bearing liabilities fell by only 13 basis points. Also impacting the rate variance for the year-to-date period were interest reversals on loans placed on non-accrual status, and interest recoveries on loans that were removed from non-accrual status. As with the comparative quarters, the impact was favorable for the year-to-date comparison since net interest recoveries totaled

$146,000 in the first nine months of 2012 as opposed to net interest reversals of $145,000 in the first nine months of 2011.

The Company's net interest margin for the first nine months of 2012 was 4.29%, a drop of 35 basis points relative to the net interest margin of 4.64% in the first nine months of 2011. For the year-to-date period, negative forces include the concentration of asset growth in lower yielding investment securities, lower yields on reinvested investment balances, and a 24 basis point drop in the weighted average yield on loans. Positive developments include movement from higher-cost time deposits into lower-cost core deposits, including a $43 million increase in the average balance of non-interest bearing demand deposits, an $8 million increase in average equity, and the favorable differential in net interest recoveries/reversals.

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Provision for loan and LEASE losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as the provision for loan and lease losses. The severity of economic challenges has contributed to higher loan loss provisions for the past several years than in prior periods of strong economic growth, due to the negative impact of recessionary conditions on many of our borrowers and the resulting credit challenges in our loan portfolio. The Company's loan loss provision totaled $4.700 million for the third quarter of 2012, and $10.610 million for the first nine months of 2012. The loss provision was increased by $1.700 million, or 57%, in the third quarter of 2012 relative to the third quarter of 2011, and reflects an increase of $1.010 million, or 11% for the first nine months of 2012 relative to the first nine months of 2011.

The Company's loan loss provision has been sufficient to maintain an allowance for loan and lease losses at a level that, in management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans, as well as probable incurred losses in the remaining loan portfolio. Specifically identifiable and quantifiable loan losses are immediately charged off against the allowance, and net loans charged off in the third quarter of 2012 totaled $5.757 million relative to $3.219 million in the third quarter of 2011. For the first nine months, net loans charged off totaled $15.087 million in 2012 relative to $10.246 million in 2011. The Company's loan loss provision has been lower than loan charge-offs thus far in 2012, since many of the charge-offs were taken against previously-established specific reserves and did not directly result in the need for reserve replenishment via the loan loss provision. The level of charge-offs also affects historical loss factors used in calculating general reserves for non-impaired loans, and higher loss factors can lead to a larger loan loss provision if it is determined that general reserves require enhancement. While this occurred to some extent in 2012, the impact was partially offset by the adjustment of qualitative factors pursuant to management's determination that credit risk in non-impaired loans has declined, as discussed in further detail below under "Allowance for Loan and Lease Losses." Our loan loss provision in 2012 and 2011 has been utilized primarily to establish specific reserves on loans migrating into impaired status and enhance specific reserves on other impaired collateral-dependent loans that might have experienced deterioration in the value of their underlying collateral, but it has also been used in part to build general reserves due to higher historical loss factors and to establish reserves for net growth in performing loan balances.

The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed in note 12 to the consolidated financial statements and below under "Allowance for Loan and Lease Losses." The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company's loan loss provision, and consequently in our net earnings.

NON-INTEREST INCOME and OPERATING expense

The following table provides details on the Company's non-interest income and operating expense for the third quarter and first nine months of 2012, as well as the third quarter and first nine months of 2011:

Non Interest Income/Expense
(dollars in thousands, unaudited)

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012	% of Total	2011	% of Total	2012	% of Total	2011	% of Total
OTHER OPERATING INCOME:								
Service charges on deposit accounts	$2,525	64.81 %	$2,439	72.39 %	$7,229	59.15 %	$7,140	68.53 %
Other service charges, commissions & fees	1,329	34.11 %	1,320	39.18 %	3,968	32.47 %	3,212	30.83 %
Gains on sales of loans	45	1.16 %	40	1.19 %	139	1.14 %	93	0.89 %
Gains on securities	90	2.31 %	-	0.00 %	161	1.32 %	-	0.00 %
Loan servicing income	4	0.10 %	4	0.12 %	10	0.08 %	11	0.11 %
Bank owned life insurance	392	10.06 %	(197)	-5.85 %	1,135	9.29 %	433	4.16 %
Other	(489)	-12.55 %	(237)	-7.03 %	(421)	-3.45 %	(471)	-4.52 %
Total non-interest income	$3,896	100.00 %	$3,369	100.00 %	$12,221	100.00 %	$10,418	100.00 %
As a % of average interest-earning assets (1)		1.23 %		1.10 %		1.34 %		1.17 %
OTHER OPERATING EXPENSES:								
Salaries and employee benefits	$5,278	47.93 %	$4,849	45.88 %	$15,855	47.14 %	$15,760	46.59 %
Occupancy costs								
Furniture & equipment	529	4.80 %	640	6.06 %	1,533	4.56 %	1,689	4.99 %
Premises	1,140	10.35 %	1,147	10.85 %	3,188	9.48 %	3,298	9.75 %
Advertising and marketing costs	372	3.38 %	599	5.67 %	1,323	3.93 %	1,515	4.48 %
Data processing costs	480	4.36 %	444	4.20 %	1,327	3.95 %	1,107	3.27 %
Deposit services costs	574	5.21 %	666	6.30 %	1,743	5.18 %	1,913	5.65 %
Loan services costs								
Loan processing	304	2.76 %	255	2.41 %	862	2.56 %	700	2.07 %
Foreclosed assets	282	2.56 %	469	4.44 %	2,028	6.03 %	2,193	6.48 %
Other operating costs								
Telephone & data communications	378	3.43 %	302	2.86 %	1,109	3.30 %	959	2.84 %
Postage & mail	175	1.59 %	155	1.47 %	517	1.54 %	441	1.30 %
Other	185	1.68 %	219	2.07 %	558	1.65 %	641	1.90 %
Professional services costs								
Legal & accounting	298	2.71 %	381	3.61 %	1,021	3.04 %	1,197	3.54 %

Other professional service	617	5.60	%	104	0.99	%	1,592	4.73	%	1,585	4.69	%
Stationery & supply costs	151	1.38	%	198	1.87	%	562	1.67	%	533	1.58	%
Sundry & tellers	248	2.26	%	140	1.32	%	417	1.24	%	294	0.87	%
Total non-interest Expense	$11,011	100.00	%	$10,568	100.00	%	$33,635	100.00	%	$33,825	100.00	%
As a % of average interest-earning assets (1)		3.49	%		3.46	%		3.68	%		3.81	%
Efficiency Ratio (2)	61.45 %			60.54 %			64.20 %			64.61 %		

(1) Annualized

(2) Tax Equivalent

The Company's results reflect an increase in total non-interest income of $527,000, or 16%, for the third quarter of 2012 relative to the third quarter of 2011. For the first nine months of 2012 the increase in non-interest income was $1.803 million, or 17%, relative to the first nine months of the prior year. As discussed in greater detail below, significant variances contributing to the increases for the third quarter and year-to-date period in 2012 include favorable fluctuations in income on bank-owned life insurance (BOLI) associated with deferred compensation plans, and higher interchange fees on debit card transactions. The year-to-date comparison was further impacted by accrual adjustments on low-income housing tax credit investment costs and other limited partnership investments. Despite a substantially higher level of average interest-earning assets, total other operating income increased to an annualized 1.23% of average interest-earning assets in the third quarter of 2012 from 1.10% in the third quarter of 2011, and was an annualized 1.34% of average earning assets for the first nine months of 2012 relative to 1.17% for the first nine months of 2011.

Service charge income on deposits increased by $86,000, or 4%, for the quarterly comparison, and by $89,000, or 1%, for the year-to-date comparison. Fees for higher risk deposit accounts were instituted in the fourth quarter of 2011 and totaled $143,000 in the third quarter of 2012 and $434,000 for the first nine months of 2012, but those fees were offset to a great extent by a drop in returned item and overdraft charges totaling $98,000 for the quarter and $309,000 for the first nine months. Other service charges, commissions, and fees increased by $9,000, or 1%, for the quarter and were up by $756,000, or 24%, for the year-to-date period, due in part to fluctuations in pass-through operating costs associated with our investments in low-income housing tax credit funds and other limited partnership investments. Those expenses, which are netted out of non-interest income, increased by $85,000 for the quarter (thus reducing income by a like amount), but reflect a drop of $396,000 for the year-to-date comparison (thus increasing income), due mainly to accrual adjustments. We also had quarterly and year-to-date increases in debit card point-of-sale interchange fees, rental income on OREO properties, and various other fee income categories.

The Company realized investment gains of $90,000 in the third quarter and $161,000 for the first nine months of 2012, due to the successful third-quarter sale of a few municipal bonds that were below our desired ratings and the first-quarter “clean-up” sale of a large number of odd-lot mortgage-backed securities. There were no gains on securities during the first nine months of 2011. Loan servicing income remained at minimal levels, but loan sale income reflects a modest increase in 2012 due to an increase in mortgage loans originated and subsequently sold.

Bank-owned life insurance income increased by $589,000, or 299%, in the third quarter, and by $702,000, or 162%, for the first nine months of 2012 relative to 2011. The fluctuations are primarily the result of income and losses on BOLI associated with deferred compensation plans, which is classified as “separate account” BOLI. The Company owns and derives income from two basic types of BOLI: “general account,” and “separate account.” At September 30, 2012 the Company had $34.5 million invested in single-premium general account BOLI, which includes a $5.0 million BOLI purchase consummated at the end of the third quarter of 2011. Income from our general account BOLI is used to fund expenses associated with executive salary continuation plans, director retirement plans and other employee benefits, and is typically fairly consistent with interest credit rates that do not change frequently. In addition to general account BOLI, the Company had $3.2 million invested in separate account BOLI at September 30, 2012, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses which often contribute to significant fluctuations in income from period to period. There was a gain on separate account BOLI totaling $126,000 in the third quarter of 2012 relative to a loss of $439,000 in the third quarter of 2011, for a net increase of $565,000 in deferred compensation BOLI income for the quarter. For the first nine months, net gains on separate account BOLI were $321,000 in 2012 while we had net losses of $306,000 in 2011, resulting in an increase of $627,000 for the comparative periods. As noted, gains and losses on separate account BOLI are related to participant gains and losses on deferred compensation balances. Participant gains are accounted for as expense accruals which, combined with their associated tax impact, effectively offset income on separate account BOLI, while participant losses result in expense accrual reversals that effectively offset losses on separate account BOLI.

The “Other” category under non-interest income includes gains and losses on the disposition of real properties and other assets, life insurance proceeds, and rental income generated by the Company’s alliance with Investment Centers of America (ICA). Other non-interest income declined by $252,000 in the third quarter of 2012 in comparison to the third quarter of 2011, but was up by $50,000 for the year-to-date comparison. The fluctuations are due in part to larger net losses on the sale of OREO in 2012. The net loss on OREO sales totaled $555,000 in the third quarter of 2012 relative to a net loss of $274,000 in the third quarter of 2011, and the net loss on the sale of OREO was $579,000 for the first nine months of 2012 relative to a loss of $569,000 in the first nine months of 2011. Partially offsetting higher OREO losses was non-recurring income of $87,000, representing life insurance proceeds received in the third quarter of 2012.

Total operating expense (non-interest expense) was $11.011 million for the quarter ended September 30, 2012, an increase of $443,000, or 4%, relative to total operating expense in the third quarter of 2011. As detailed below, a principle factor in this increase was higher accruals for deferred compensation (related to the increase in BOLI income discussed above). Non-interest expense increased to an annualized 3.49% of average interest-earning assets for the third quarter of 2012 from 3.46% in the third quarter of 2011. For the comparative year-to-date periods, non-interest expense fell by $190,000, or 1%, primarily due to favorable variances in occupancy expense, marketing expense, deposit services expense, foreclosed asset costs, and legal costs associated with loan collections, partially offset by higher deferred compensation accruals and the unfavorable variance resulting from $181,000 in non-recurring vendor credits received in the first quarter of 2011 for prior-year overcharges. Non-interest expenses were an annualized 3.68% of average earning assets for the first nine months of 2012, relative to 3.81% in the first nine months of 2011.

The largest component of non-interest expense, salaries and employee benefits, increased by $429,000, or 9%, for the quarter, and by $95,000, or 1%, for the year-to-date comparison. The increase in salaries and benefits is due in large part to higher deferred compensation accruals, which were up by $376,000 for the comparative quarters and by $293,000 for the year-to-date period. There were also fluctuations 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. Those deferrals declined by $41,000 for the quarter, but increased by $96,000 for the first nine months. The quarterly and year-to-date increases in salaries and benefits were further impacted by regular annual salary increases, and the limited addition of staff to accommodate loan growth. Salaries and benefits increased to 47.93% of total non-interest expense for the third quarter of 2012 from 45.88% in the third quarter of 2011, and to 47.14% of total non-interest expense for the first nine months of 2012 from 46.59% in the first nine months of 2011.

Total occupancy expense reflects declines of $118,000, or 7%, for the third quarter of 2012 and $266,000, or 5%, for the first nine months of 2012, due in part to lower costs resulting from the purchase of our headquarters office building in the fourth quarter of 2011. Marketing costs declined by $227,000, or 38%, for the quarter and by $192,000, or 13%, for the first nine months, with the fluctuations due in large part to the timing of payments. Data processing costs reflect a small increase for the quarter, but were up by $220,000, or 20%, for the comparative year-to-date periods due mainly to $181,000 in non-recurring vendor credits received in the first quarter of 2011, as noted above. Deposit services costs fell by $92,000, or 14%, for the quarter and $170,000, or 9%, for the year-to-date period, due in part to a $75,000 non-recurring expense offset in the third quarter of 2012 in conjunction with the renewal of our contract for processing debit card transactions. The variance in deposit costs was also favorably impacted by lower operating costs associated with online deposit products, debit card processing and other miscellaneous deposit cost categories.

Loan processing costs increased by $49,000, or 19%, for the quarter and by $162,000, or 23%, for the year-to-date period, due in large part to higher foreclosure costs. The year-to-date variance was further impacted by a $37,000 addition to our reserve for unfunded commitments in the first quarter of 2012. Foreclosed asset costs declined by $187,000, or 40%, for the quarter, and by $165,000, or 8%, for the first nine months. The drop for the quarter is due to a $136,000 reduction in OREO write-downs and a $51,000 decline in OREO operating expense, while for the year-to-date comparison the reduction in OREO write-downs was $46,000 and the decline in OREO operating expense was $119,000. OREO write-downs totaled $215,000 and $1.610 million for the third quarter and first nine months of 2012, respectively, while OREO operating expense was $67,000 and $418,000 for the third quarter and first nine months of 2012, respectively.

Telecommunications costs increased by $76,000, or 25%, for the quarter and by $150,000, or 16%, for the first nine months, due to costs associated with the addition and enhancement of data circuits. Postage and mail costs increased by $20,000, or 13%, for the quarter and by $76,000, or 17%, for the first nine months, due in large part to increased mailings for required overdraft disclosures and costs associated with a direct-mail marketing campaign targeting commercial loans. The small drop in the "other" category under other operating costs is due in part to lower depreciation expense on operating leases where the Bank is lessor, as the result of the maturity of certain leases.

Under professional services costs, legal and accounting costs declined by $83,000, or 22%, for the quarter and by $176,000, or 15%, for the first nine months, due in large part to a drop in legal costs associated with loan collections. The cost of other professional services increased by $513,000, or 493%, for the third quarter but was up by only $7,000 for the first nine months. The increase for the quarter is the result of a $373,000 increase in directors' deferred compensation accruals (related to the increase in BOLI income discussed above), and a $215,000 increase in regulatory assessment accruals resulting from an accrual adjustment in the third quarter of 2011, partially offset by reductions in various other professional services costs. For the comparative year-to-date periods, a $338,000 increase in directors' deferred compensation accruals was offset by a $167,000 decline in the accrual for regulatory assessments, as well as reductions in various other professional services costs. Our year-to-date accruals for regulatory assessments declined due to lower overall assessment rates and the Company's reduced risk profile. The cost of supplies fell by $47,000 for the third quarter due to the timing of payments, but increased by $29,000 for the first nine months of 2012 due primarily to the restocking of operations-related forms and supplies earlier in the year. Sundry and teller losses increased by $108,000, or 77%, for the third quarter and by $123,000, or 42%, for the year-to-date comparison, due to a surge in debit card fraud in the third quarter of 2012. Our debit card processor implemented additional fraud detection and prevention capabilities in October 2012 which should reduce losses from levels experienced in the third quarter of 2012, although no assurance can be provided in that regard.

The Company's tax-equivalent overhead efficiency ratio increased to 61.45% in the third quarter of 2012 from 60.54% in the third quarter of 2011, but fell slightly to 64.20% for the first nine months of 2012 from 64.61% for the first nine months of 2011. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains and losses, and other extraordinary gains and losses excluded from the equation.

PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company's statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. Our tax credits consist primarily of those generated by a $9.0 million investment in low-income housing tax credit funds, and California state employment tax credits. Because of the relatively high portion of the Company's pretax income that consists of tax-exempt interest income and BOLI income, and the level of tax credits available in relation to our pre-credit tax liability, as calculated for book purposes, our tax accrual rate is currently very sensitive to changes in pretax income. The referenced factors resulted in a tax benefit of $321,000 in the third quarter of 2012 and a tax provision of $822,000, or 25% of pre-tax income, in the third quarter of 2011. The tax benefit in the third quarter of 2012 reduced the year-to-date tax provision to just $54,000, or slightly less than 1% of pre-tax income, while the provision was 11% of pre-tax income for the first nine months of 2011. The lower tax provisioning rate for 2012 is primarily the result of lower taxable income relative to the Company's available tax credits, and the third quarter of 2012 was impacted further by a sizeable increase in tax-exempt BOLI income.

balance sheet analysis

EARNING ASSETS

INVESTMENTS

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

The Company's investments consist of debt and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank account, and overnight fed funds sold. Surplus Federal Reserve Bank balances and fed funds sold to correspondent banks represent the investment of temporary excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments were 29% of total assets at September 30, 2012, compared to 32% at December 31, 2011.

We had no fed funds sold at September 30, 2012 or December 31, 2011. Our balance of interest-bearing balances at other banks was $3 million at September 30, 2012, down from $20 million at the end of 2011 as excess balance sheet liquidity was utilized to help fund growth in loan balances in the second and third quarters of 2012. In the first quarter of 2012, surplus liquidity which was generated from growth in deposits and loan runoff was deployed into longer-term, agency-issued mortgage-backed securities and municipal bonds, hence the book balance of the Company's investment portfolio reflects an increase of $8 million, or 2%, for the first nine months of 2012. The book balance of our investment securities was $415 million at September 30, 2012. 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.

The following table sets forth the Company's investment portfolio by investment type as of the dates noted:

Investment Portfolio

(dollars in thousands, unaudited)	September 30, 2012		December 31, 2011	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Available for Sale				
US Government Agencies & Corporations	$1,129	$1,134	$2,008	$2,026
Mortgage-backed securities	325,605	330,627	328,751	331,758
State & political subdivisions	76,558	80,963	67,851	71,340
Equity securities	1,336	1,911	1,336	1,347
Total Investment Securities	$404,628	$414,635	$399,946	$406,471

U.S. Government agency securities were down by close to $1 million, or 44%, for the first nine months of 2012, due to balances that matured but were not reinvested. Mortgage-backed securities declined by slightly more than $1 million, or less than 1%, during the same time frame, as purchases were not of sufficient volume to make up for the "clean-up" sale of a large number of odd-lot mortgage-backed securities totaling $3.1 million in book value, as well as prepayments. The balance of municipal bonds increased by $10 million, or 13%, as the Company has taken advantage of relative value in that sector. It should be noted that all newly purchased municipal bonds have strong underlying ratings. No equity securities were bought or sold during the first nine months of 2012, although the market value of those securities increased by $564,000, or 42%. Investment portfolio securities that were pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled $227 million at September 30, 2012 and $208 million at December 31, 2011, leaving $185 million in unpledged debt securities at September 30, 2012 and $197 million at December 31, 2011. Securities pledged in excess of actual pledging needs, and thus available for liquidity purposes if necessary, totaled $124 million at September 30, 2012 and $112 million at December 31, 2011.

Loan Portfolio

The Company's loans and leases, gross of the associated allowance for losses and deferred fees and origination costs but not including loans held for sale, totaled $847 million at September 30, 2012, an increase of $90 million, or 12%, since December 31, 2011. Loan balances had been declining for the past few years due to reductions associated with the resolution of impaired loans and runoff in the normal course of business, but they experienced a significant increase in the second and third quarters of 2012 due to growth in balances outstanding on mortgage warehouse lines (a subcomponent of commercial and industrial loans). A comparative schedule of the distribution of the Company's loans at September 30, 2012 and December 31, 2011, by outstanding balance as well as by percentage of total loans, is presented in the following Loan and Lease Distribution table. The balances shown for each loan type are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs.

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Loan and Lease Distribution
(dollars in thousands, unaudited)

	September 30, 2012		December 31, 2011	
Real Estate:				
1-4 family residential construction	$ 7,012		$ 8,488	
Other Construction/Land	34,944		40,060	
1-4 family - closed-end	101,600		104,953	
Equity Lines	61,892		66,497	
Multi-family residential	5,201		8,179	
Commercial real estate- owner occupied	175,167		183,070	
Commercial real estate- non-owner occupied	91,815		105,843	
Farmland	61,934		60,142	
Total Real Estate	539,565		577,232	
Agricultural products	20,969		17,078	
Commercial and Industrial	231,154		99,408	
Small Business Administration Loans	20,228		21,006	
Direct finance leases	4,743		6,743	
Consumer loans	30,471		36,124	
Total Loans and Leases	$ 847,130		$ 757,591	
Percentage of Total Loans and Leases				
Real Estate:				
1-4 family residential construction	0.83	%	1.12	%
Other Construction/land	4.12	%	5.29	%
1-4 family - closed-end	11.99	%	13.85	%
Equity Lines	7.31	%	8.78	%
Multi-family residential	0.61	%	1.08	%
Commercial real estate- owner occupied	20.68	%	24.16	%
Commercial real estate- non-owner occupied	10.84	%	13.97	%
Farmland	7.31	%	7.94	%
Total Real Estate	63.69	%	76.19	%
Agricultural products	2.48	%	2.26	%
Commercial and Industrial	27.29	%	13.12	%
Small Business Administration Loans	2.39	%	2.77	%
Direct finance leases	0.55	%	0.89	%
Consumer loans	3.60	%	4.77	%
Total Loans and Leases	100.00	%	100.00	%

As shown above, commercial loans increased by $132 million, or 133%, during the first nine months of 2012. Balances outstanding on mortgage warehouse lines were up $126 million, with net growth of about $6 million in other commercial loan categories. With that growth, commercial loans increased to 27.29% of total loans at September 30, 2012 from 13.12% at December 31, 2011. While the Company has engaged in mortgage warehouse lending on a limited basis for the past seven years, the recent surge in balances is primarily the result of hiring an experienced mortgage warehouse lender with contacts throughout California, our implementation of new software to automate the process and provide additional internal controls, and recent market opportunities created by an increase in refinancing activity and the decision by certain competitors to focus principally on larger mortgage lenders. Since mortgage lending activity is strongly correlated to interest rates and has historically been subject to significant fluctuations, no assurance can be provided with regard to our ability to maintain or continue to grow mortgage warehouse balances.

Agricultural production loans also increased by $4 million, or 23%, for the first nine months. Most other major loan categories show declining balances, or at best very little growth, due in part to reductions related to the resolution of nonperforming loans. Total real estate loans, in particular, declined by $38 million, or 7%, with $23 million of the decline due to a reduction in nonperforming real estate loans. Consumer loans fell by $6 million, or 16%, due to a general lack of activity in the consumer lending arena.

Management has made selective personnel changes over the past several quarters and has established branch objectives weighted toward high-quality loan growth, to help ensure that growth is not concentrated solely in one segment of the portfolio and to counter factors that have impeded the Company's loan growth for the past few years, such as weak loan demand, tightened credit criteria for real estate loans, and heightened competition. Furthermore, there is anecdotal evidence that certain sectors of the local economy are beginning to improve, which could also benefit loan growth. We have seen a recent increase in lending activity in areas other than mortgage warehouse loans, but no assurance can be provided that this will be sustained and that loan growth will continue, especially in the near term.

Although not reflected in the loan totals above and not currently comprising a material segment of our lending activities, the Company occasionally originates and sells, or participates out portions of, certain commercial real estate loans, agricultural or residential mortgage loans, and other loans to non-affiliated investors, and we currently provide servicing for a small number of SBA loans.

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. 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. The following table presents comparative data for the Company's nonperforming assets and performing TDR's, as of the dates noted:

Nonperforming Assets and Performing TDR's

(dollars in thousands, unaudited)	September 30, 2012	December 31, 2011	September 30, 2011
NON-ACCRUAL LOANS:			
Real Estate:			
1-4 family residential construction	$ 1,558	$ 2,244	$ 3,846
Other Construction/Land	1,349	4,083	5,227
1-4 family - closed-end	5,591	7,605	6,412
Equity Lines	732	1,309	2,481
Multi-family residential	-	2,941	-
Commercial real estate- owner occupied	6,409	7,086	8,921
Commercial real estate- non-owner occupied	5,193	13,958	10,425
Farmland	1,943	6,919	492
TOTAL REAL ESTATE	22,775	46,145	37,804
Agriculture Products	999	-	-
Commercial and Industrial	1,307	3,778	4,432
Small Business Administration Loans	2,331	3,452	3,776
Direct finance leases	190	591	707
Consumer loans	1,252	2,144	1,825
TOTAL NONPERFORMING LOANS	28,854	56,110	48,544
Foreclosed assets	19,835	15,364	18,185
Total nonperforming assets	$ 48,689	$ 71,474	$ 66,729
Performing TDR's (1)	$ 36,888	$ 36,058	$ 34,426
Nonperforming loans as a % of total gross loans and leases	3.41 %	7.41 %	6.40 %
Nonperforming assets as a % of total gross loans and leases and foreclosed assets	5.62 %	9.25 %	8.59 %

(1) Performing TDRs are not included in nonperforming loans above, nor are they included in the numerators used to calculate the ratios disclosed in this table.

Total nonperforming assets dropped by $22.8 million, or 32%, during the first nine months of 2012. Nonperforming loans were down by $27.3 million, or 49%, however foreclosed assets increased by $4.5 million, or 29%. The balance of nonperforming loans at September 30, 2012 includes $14.5 million in TDR’s and other loans that were paying as agreed under modified terms or forbearance agreements but were still classified as nonperforming. As shown in the table, we also had $36.9 million in loans classified as performing TDR’s for which we were still accruing interest at September 30, 2012, a slight increase relative to the balance of $36.1 million at December 31, 2011.

Non-accruing loan balances secured by real estate comprised $22.8 million of total nonperforming loans at September 30, 2012, and reflect a net decrease of $23.4 million, or 51%, during the first nine months of 2012. The reduction includes net pay-downs on nonperforming real estate loans of $8.8 million, transfers to OREO from nonperforming real estate loans totaling $19.4 million, charge-offs on nonperforming real estate loans of $7.2 million, and $1.7 million in balances returned to accrual status. Those reductions were partially offset by $13.6 million in gross additions to nonperforming real estate loans for the first nine months of 2012.

Nonperforming commercial and SBA loans declined by a combined $3.6 million, or 50%, during the first nine months of 2012, ending the period at $3.6 million. Gross additions to nonperforming commercial and SBA loans totaled $794,000 for the nine months ended September 30, 2012, but this was more than offset by net pay-downs of $1.7 million, the charge-off of $2.6 million in loan balances, and the return to accrual status of $175,000 in loans. Non-accrual direct finance leases declined by $401,000, or 68%, during first nine months of 2012, due primarily to charge-offs; and, nonperforming consumer loans, which are largely unsecured, dropped by $892,000, or 42%, also due largely to charge-offs.

As noted above, foreclosed assets increased by $4.5 million, or 29%, during the first nine months of 2012, due to the migration of $19.4 million in nonperforming real estate loans into OREO, less OREO sold during that period and any write-downs. A few large loans, in particular, which were foreclosed on during the first nine months of 2012 were subsequently sold as OREO during the same period. The balance of foreclosed assets at September 30, 2012 had an aggregate carrying value of $19.8 million, and was comprised of 73 properties classified as OREO and two mobile homes. Much of our OREO consists of vacant lots or land, but there are also 11 residential properties totaling $1.5 million and ten commercial buildings with a combined book balance of $7.2 million. At the end of 2011 foreclosed assets totaled $15.4 million, comprised of 66 properties in OREO and five mobile homes. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value.

Total nonperforming assets were 5.62% of gross loans and leases plus foreclosed assets at September 30, 2012, down substantially from 9.25% at December 31, 2011 due to the reduction in nonperforming assets and growth in loans. An action plan is in place for each of our non-accruing loans and foreclosed assets and they are all being actively managed. Collection efforts are continuously pursued for all nonperforming loans, but we cannot provide assurance that all will be resolved in a timely manner or that nonperforming balances will not increase further.

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. It is maintained at a level that is considered adequate to absorb probable losses on certain specifically identified loans, as well as probable incurred losses inherent in the remaining loan portfolio. 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. An allowance for potential losses inherent in unused commitments, totaling $197,000 at September 30, 2012, is included in other liabilities.

At September 30, 2012, the Company’s allowance for loan and lease losses was $12.8 million, or 1.51% of gross loans, relative to the $17.3 million allowance at December 31, 2011 which was 2.28% of gross loans. The $4.5 million reduction in the first nine months of 2012 was due in part to the write-down of certain impaired collateral-dependent loan balances against previously-established specific reserves, which did not directly lead to the need for reserve replenishment, as well as a reduction in general reserves consistent with the Company’s improvement in asset quality. Relative to its balance at September 30, 2011 the allowance declined by $7.7 million, or 38%, due again in large part to the charge-off of balances with previously-established specific reserves during the latter part of 2011 and the first nine months of 2012. The Company’s total allowance was 44.38% of nonperforming loans at September 30, 2012, an increase relative to 30.80% at December 31, 2011 and 42.21% at September 30, 2011 due to the drop in nonperforming loans.

In addition to the reduction in the overall allowance for loan and lease losses, its composition shifted somewhat during the first nine months of 2012. Despite a significant level of charge-offs against previously-established specific reserves, reserves for impaired loans declined by only $3 million during the first nine months of 2012, since the impact of charge-offs was partially offset by the establishment of specific reserves for loans migrating to impaired status and by enhancements to reflect updated expectations with regard to realizable values. Moreover, notwithstanding the increase in outstanding loan balances, general reserves for incurred losses on performing loans declined by $1 million, or 16%. The decline in general reserves is due to the adjustment of qualitative factors, to reflect management's assessment that default risk has declined as certain higher-risk balances originated prior to the recession have migrated out of performing loans due to payoffs or performance issues, and the remaining loans, many of which were originated subsequent to the beginning of the recession using more stringent credit criteria, have become better seasoned and are less likely to experience losses. The decline in the allowance for loan and lease losses resulting from the adjustment of qualitative factors was partially offset by the establishment of loss reserves for new loan growth, and the refinement of proxy loss rates which are incorporated into the model when there is insufficient data to utilize the Bank's own historical loan rates.

The table that follows summarizes the activity in the allowance for loan and lease losses for the noted periods:

Allowance for Loan and Lease Losses

(dollars in thousands, unaudited)	For the Three Months Ended September 30, 2012	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011	For the Year Ended December 31, 2011
Balances:					
Average gross loans and leases outstanding during period(1)	$ 813,962	$ 759,512	$ 775,395	$ 772,979	$ 767,901
Gross loans and leases outstanding at end of period	$ 847,130	$ 757,783	$ 847,130	$ 757,783	$ 757,591
Allowance for Loan and Lease Losses:					
Balance at beginning of period	$ 13,863	$ 20,711	$ 17,283	$ 21,138	$ 21,138
Provision charged to expense	4,700	3,000	10,610	9,600	12,000
Charge-offs					
Real Estate					
1-4 family residential construction	46	-	46	-	1,389
Other Construction/Land	1,117	74	1,856	1,170	1,807
1-4 family - closed-end	205	119	1,239	408	795
Equity Lines	60	280	982	820	1,776
Multi-family residential	102	-	1,262	-	-
Commercial real estate- owner occupied	906	186	1,530	977	1,306
Commercial real estate- non-owner occupied	1,342	1,470	2,093	2,875	3,027
Farmland	-	-	171	-	496
TOTAL REAL ESTATE	3,778	2,129	9,179	6,250	10,596
Agricultural products	634	-	634	-	-
Commercial & industrial loans	675	592	3,215	2,402	3,407
Small Business Administration Loans	335	3	753	128	148
Direct Finance Leases	-	23	198	33	82
Consumer Loans	526	718	1,873	2,048	2,754
Total	$ 5,948	$ 3,465	$ 15,852	$ 10,861	$ 16,987
Recoveries					
Real Estate					
1-4 family residential construction	-	-	-	-	133
Other Construction/Land	10	-	14	38	38
1-4 family - closed-end	6	7	30	16	23
Equity Lines	3	1	16	3	4

Multi-family residential	-	-	-	-	-
Commercial real estate- owner occupied	2	-	93	1	71
Commercial real estate- non-owner occupied	12	1	12	1	148
Farmland	-	1	57	2	1
TOTAL REAL ESTATE	33	10	222	61	418
Agricultural products	-	-	-	-	323
Commercial and Industrial	70	120	262	245	71
Small Business Administration Loans	35	-	82	69	57
Direct Finance Leases	-	31	-	45	263
Consumer Loans	53	85	199	195	-
Total	$ 191	$ 246	$ 765	$ 615	$ 1,132
Net loan charge offs (recoveries)	$ 5,757	$ 3,219	$ 15,087	$ 10,246	$ 15,855
Balance at end of period	$ 12,806	$ 20,492	$ 12,806	$ 20,492	$ 17,283
RATIOS					
Net Charge-offs to Average Loans and Leases (annualized)	2.81 %	1.68 %	2.60 %	1.77 %	2.06 %
Allowance for Loan Losses to Gross Loans and Leases at End of Period	1.51 %	2.70 %	1.51 %	2.70 %	2.28 %
Allowance for Loan Losses to NonPerforming Loans at end of period	44.38 %	42.21 %	44.38 %	42.21 %	30.80 %
Net Loan Charge-offs to Allowance for Loan Losses at End of Period	44.96 %	15.71 %	117.81 %	50.00 %	91.74 %
Net Loan Charge-offs to Provision for Loan Losses	122.49 %	107.30 %	142.20 %	106.73 %	132.13 %

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

As shown in the table immediately above, the Company's provision for loan and lease losses was increased by $1.700 million, or 57%, for the third quarter of 2012 relative to the third quarter of 2011, and by 1.010 million, or 11%, for the first nine months of 2012 relative to the first nine months of 2011. Net loans charged off were up by $2.538 million, or 79%, for the quarterly comparison, and increased by $4.841 million, or 47%, for the first nine months in 2012, for the reasons noted above. Real estate loan charge-offs experienced the largest increase among our major loan categories, rising by $1.649 million, or 77%, for the comparative quarters, and by $2.929 million, or 47%, for the year-to-date comparison, since many of charge-offs in 2012 were write-downs on collateral-dependent loans. Including write-downs taken in the first nine months of 2012, we have taken a cumulative total of $4.4 million in write-downs on collateral-dependent loans still on our books at September 30, 2012, most of which were on construction loans. A higher level of principal recoveries on nonperforming loans that were resolved in the first nine months of 2012 provided a small offset to the increase in gross charge-offs, including an increase of $161,000 in recoveries on real estate loans. Since our allowance for loan and lease losses is maintained at a level to cover probable losses on specifically identified loans as well as probable incurred losses in the remaining loan portfolio, any shortfall in the allowance created by loan charge-offs is typically covered by month-end, and always by quarter-end. Additional details on our provision for loan and lease losses and its relationship to actual charge-offs is contained above in the "Provision for Loan and Lease Losses" section.

The Company's allowance for loan and lease losses at September 30, 2012 represents management's best estimate of probable losses in the loan portfolio as of that date. Fluctuations in credit quality, changes in economic conditions, or other factors could induce us to augment or reduce the allowance, however, and no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance.

OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company maintains commitments to extend credit as long as there are no violations of any conditions established in the outstanding contractual arrangements. Unused commitments to extend credit totaled $240 million at September 30, 2012 and $154 million at December 31, 2011, although it is not likely that all of those commitments will ultimately be drawn down. The increase during the first nine months of 2012 was primarily due to an increase in undisbursed commitments on mortgage warehouse lines, and the addition of the unused portions of deposit account overdraft lines that were formalized during 2012. Unused commitments represented approximately 28% of gross loans outstanding at September 30, 2012, and 20% at December 31, 2011. In addition to unused loan commitments, the Company had undrawn letters of credit totaling $15 million at September 30, 2012 and $20 million at December 31, 2011.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. For more information regarding the Company's off-balance sheet arrangements, see Note 8 to the financial statements located elsewhere herein.

OTHER ASSETS

The balance of non-interest earning cash and due from banks was $42 million at September 30, 2012, compared to $43 million at December 31, 2011. Since the actual balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks), it is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its short-term cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Reserve Bank and the Federal Home Loan Bank. Should a large “short” overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a “long” position is prevalent, the Company will let brokered deposits or other wholesale borrowings roll off as they mature, or might invest excess liquidity in higher-yielding, longer-term bonds.

Because of frequent balance fluctuations, a more accurate gauge of cash management efficiency is the average balance for the period. The $37 million average of non-earning cash and due from banks for the first nine months of 2012 was higher than the $34 million average for the year in 2011, due in part to extra cash kept on hand to accommodate greater day-to-day fluctuations associated with a higher level of lending activity.

Net premises and equipment increased by $1.5 million, or 7%, during the first nine months of 2012, due mainly to the replacement of our ATM's in order to accommodate new compliance requirements, and tenant improvements associated with our relocated Clovis branch. Operating leases declined to $268,000 at September 30, 2012, from $384,000 at December 31, 2011. Foreclosed assets are discussed above, in the section titled "Nonperforming Assets." Goodwill did not change during the period, ending the first nine months of 2012 with a balance of about $6 million. The Company's goodwill is evaluated annually for potential impairment, and because the estimated fair value of the Company exceeded its book value (including goodwill) as of the measurement date and no impairment was indicated, no further testing was deemed necessary and it was determined that no goodwill impairment exists. "Other assets" declined by $1.8 million, or 2%, due primarily to a $1.3 million reduction in the net cash surrender value of bank-owned life insurance resulting from our receipt of insurance proceeds in conjunction with the passing of a retired employee. At September 30, 2012, the $79.8 million balance of other assets included as its largest components $37.7 million in bank-owned life insurance (see discussion of BOLI in "Non-Interest Revenue and Operating Expense" section above), a $9.0 million investment in low-income housing tax credit funds, a $6.4 million investment in restricted stock, a net deferred tax asset of $10.6 million, current prepaid income taxes totaling $3.3 million, accrued interest receivable totaling $5.2 million, and a prepaid regulatory assessment of $2.0 million. Restricted stock is comprised primarily of Federal Home Loan Bank of San Francisco ("FHLB") stock that would typically experience balance fluctuations in conjunction with changes in our FHLB borrowings. However, the FHLB suspended stock repurchases for a period of time and is currently repurchasing stock at minimal levels, thus our restricted stock investment is not expected to drop significantly even with a lower level of borrowings. Our FHLB stock is not deemed to be marketable or liquid and is thus not grouped with the Company's investments described above. Our net deferred tax asset is evaluated as of every reporting date pursuant to FASB guidance, and we have determined that no impairment exists.

DEPOSITS AND INTEREST BEARING LIABILITIES

DEPOSITS

Another key balance sheet component impacting the Company's net interest margin is our deposits. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly non-maturity deposits, which include demand deposit accounts, NOW accounts, savings accounts, and money market demand accounts. Information concerning average balances and rates paid on deposits by deposit type for the quarters and nine-month periods ended September 30, 2012 and 2011 is contained in the Average Rates and Balances tables appearing above in the section titled "Net Interest Income and Net Interest Margin." A comparative schedule of the distribution of the Company's deposits at September 30, 2012 and December 31, 2011, by outstanding balance as well as by percentage of total deposits, is presented in the following Deposit Distribution table.

Deposit Distribution
(dollars in thousands, unaudited)

	September 30, 2012	December 31, 2011
Interest Bearing Demand Deposits	$ 67,938	$ 68,777
Non-interest Bearing Demand Deposits	323,184	300,045
NOW	195,634	187,155
Savings	112,025	91,376
Money Market	72,266	76,396
CDAR's < $100,000	976	943
CDAR's ≥ $100,000	17,723	17,119
Customer Time deposit < $100,000	114,734	106,610
Customer Time deposits ≥ $100,000	226,373	222,847
Brokered Deposits	15,000	15,000
Total Deposits	$ 1,145,853	$ 1,086,268

Percentage of Total Deposits				
Interest Bearing Demand Deposits	5.93	%	6.33	%
Non-interest Bearing Demand Deposits	28.20	%	27.62	%
NOW	17.07	%	17.23	%
Savings	9.78	%	8.41	%
Money Market	6.31	%	7.03	%
CDAR's < $100,000	0.09	%	0.09	%
CDAR's ≥ $100,000	1.55	%	1.58	%
Customer Time deposit < $100,000	10.01	%	9.81	%
Customer Time deposits ≥ $100,000	19.75	%	20.52	%
Brokered Deposits	1.31	%	1.38	%
Total Deposits	100.00	%	100.00	%

Total deposit balances increased by $60 million, or 5%, during the first nine months of 2012, with most of that growth occurring during the first six months of the year. Our deposit mix has improved in 2012 since most of the growth came in core non-maturity deposits, which were up by $47 million, or 7%, for the first nine months of the year. Our customers appear to have a propensity to save due to lingering economic uncertainties, but the growth in non-maturity deposits is also due in part to an intensified focus on business relationships and our ongoing deposit acquisition programs, including our highly successful direct mail initiatives. Those factors contributed to increases of $23 million, or 8%, in non-interest bearing demand deposits, and $8 million, or 5%, in NOW accounts. We also experienced a significant increase in savings deposits, which were up $21 million, or 23%, during the first nine months of 2012. The only non-maturity deposit category that shows a decline for the year-to-date period is money market deposits, which were down $4 million, or 5%.

Management is of the opinion that a relatively high level of core customer deposits is one of the Company’s key strengths, and we continue to focus energy toward deposit account retention and growth. Based on management’s analysis of trends in monthly average deposit balances, savings account balances appear to be on a fairly steady and consistent growth trend while transaction account and money market deposit balances seem to have leveled off over the past few months. Recent historical performance, however, is not a gauge for future performance, and no assurance can be provided that current growth trends will continue.

Customer time deposits under $100,000 increased by $8 million for the first nine months of 2012, due mainly to time deposits obtained by our Treasury department to help fund loan growth. CDAR's deposits, which are also time deposits that are primarily sourced from customers in our market areas, were relatively flat for the first nine months. Customer time deposits over $100,000 experienced growth of $4 million, or 2%, while the outstanding balance of wholesale-sourced brokered deposits remained at $15 million.

OTHER INTEREST-BEARING LIABILITIES

The Company's other interest-bearing liabilities include overnight borrowings from other banks ("fed funds purchased"), borrowings from the Federal Home Loan Bank, securities sold under agreement to repurchase, and junior subordinated debentures that consist entirely of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities (see Capital Resources section for a more detailed explanation of trust-preferred securities). In aggregate, we increased non-deposit interest-bearing liabilities by $21 million, or 32%, in the first nine months of 2012 to help fund loan growth during the second and third quarters of 2012.

The Company uses overnight and short-term FHLB advances and fed funds purchased on uncommitted lines from correspondent banks to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit is dependent on the level of pledged collateral. We had no overnight fed funds purchased on our books at September 30, 2012 or December 31, 2011, but repurchase agreement balances totaled approximately $4 million at September 30, 2012 and $3 million at December 31, 2011. Repurchase agreements represent customer "sweep accounts", where deposit balances above a specified threshold are transferred at the close of every business day into non-deposit accounts secured by investment securities. We had $48 million in overnight FHLB advances at September 30, 2012, a $31 million increase relative to the $17 million balance at the end of 2011, but long-term FHLB advances declined by $10 million during the same time frame due to balances that matured. There were no other short-term FHLB advances outstanding at September 30, 2012 or December 31, 2011. The Company had $31 million in junior subordinated debentures at September 30, 2012 and December 31, 2011.

OTHER NON-INTEREST BEARING LIABILITIES

Other non-interest bearing liabilities are principally comprised of accrued interest payable, accrued income taxes, other accrued but unpaid expenses, and certain clearing amounts. Other liabilities increased by $1 million, or 7%, during the first nine months of 2012, due in large part to a liability established in the first quarter for our $1 million capital commitment as a limited partner in a newly-launched Small Business Investment Corporation.

liquidity and market RisK MANAGEMENT

LIQUIDITY

Liquidity refers to the Company's ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. Detailed cash flow projections are reviewed by management on a monthly basis, with various scenarios applied to simulate our ability to meet liquidity needs under adverse conditions, and liquidity ratios are also calculated and reviewed on a regular basis. While these ratios are merely indicators and are not measures of actual liquidity, they are monitored closely and we are focused on maintaining adequate liquidity resources to draw upon should unexpected liquidity needs arise.

The Company, on occasion, experiences cash needs as the result of loan growth, deposit outflows, asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, draw advances against Federal Home Loan Bank lines of credit, or solicit brokered deposits if deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks, including the FHLB, totaled $196 million at September 30, 2012. An additional $151 million in credit is available from the Federal Home Loan Bank if the Company pledges sufficient additional collateral and maintains the required amount of FHLB stock. The Company is also eligible to borrow approximately $53 million at the Federal Reserve Discount Window, if necessary, based on pledged assets at September 30, 2012. Furthermore, funds can be obtained by drawing down the Company's correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of September 30, 2012, unpledged debt securities, plus pledged securities in excess of current pledging requirements, comprised $310 million of the Company's investment portfolio balances, up slightly from $309 million at December 31, 2011. Other forms of balance sheet liquidity include but are not necessarily limited to any outstanding fed funds sold and vault cash. The Company has a higher level of actual balance sheet liquidity than might otherwise be the case, since we utilize a letter of credit from the FHLB rather than investment securities for certain pledging requirements. The FHLB letter of credit totaled $74 million at September 30, 2012. Management is of the opinion that available investments and other potentially liquid assets, along with the standby funding sources it has arranged, are more than sufficient to meet the Company's current and anticipated short-term liquidity needs.

The Company’s net loans to assets and net non-core funding dependence ratios were 60% and 23%, respectively, at September 30, 2012, as compared to internal policy guidelines of “less than 78%” and “less than 50%.” Other liquidity ratios reviewed by management and the Board include net loans to total deposits, wholesale funding to total assets (including ratios and sub-limits for the various components comprising wholesale funding), and available investments to assets, all of which were well within policy guidelines at September 30, 2012. Strong growth in core deposits and growth in investments has had a positive impact on our liquidity position in recent periods, although loan growth has absorbed much of the liquidity generated during 2012 and no assurance can be provided that our liquidity position will continue at current robust levels.

INTEREST RATE RISK MANAGEMENT

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management is to manage the financial components of the Company’s balance sheet in a manner that will optimize the risk/reward equation for earnings and capital under a variety of interest rate scenarios. To identify areas of potential exposure to rate changes, the Company performs an earnings simulation analysis on a monthly basis and calculates the market value of portfolio equity under varying interest rate scenarios at least once every quarter.

The Company uses Sendero modeling software in order to simulate the effects of potential interest rate changes on net interest income and on the estimated fair values of the Company’s financial instruments. The model imports balances, interest rates, maturity dates and re-pricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to calculate the expected effect of a given interest rate change on the Company’s projected interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are applied to the Company’s investments, loans, deposits and borrowed funds. The rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

The Company uses eight standard interest rate scenarios in conducting its simulations: “stable,” upward shocks of 100, 200, 300 and 400 basis points, and downward shocks of 100, 200, and 300 basis points. Our policy is to limit any projected decline in net interest income relative to the stable rate scenario for the next 12 months to less than 5% for a 100 basis point (b.p.) shock, 10% for a 200 b.p. shock, 15% for a 300 b.p. shock, and 20% for a 400 b.p. shock in interest rates. As of September 30, 2012 the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures:

Immediate Change in Rate

	-300 b.p.	-200 b.p.	-100 b.p.	+100 b.p.	+200 b.p.	+300 b.p.	+400 b.p.
Change in Net Int. Inc. (in $000's)	$ -7,700	$ -5,425	$ -2,788	$ +1,329	$ +1,978	$ +2,486	$ +2,335
% Change	-14.91 %	-10.51 %	-5.40 %	+2.57 %	+3.83 %	+4.81 %	+4.52 %

Our current net interest income simulations indicate that the Company has an asset-sensitive profile, meaning that net interest income increases in rising interest rate scenarios but a drop in interest rates could have a negative impact. We have seen this profile steepen somewhat over the past couple of years, as we have benefited from an increasing proportion of lower-cost non-maturity deposits. The scenarios factor in the strong loan growth which occurred in the second and third quarters of 2012. This boosted net interest income for all projections, but the gain relative to base case declined for rising rate scenarios due to the subsequent adjustment of future balance sheet growth assumptions.

If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be around $2.788 million lower than in a stable interest rate scenario, a drop of 5.40%. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates are already relatively low (on NOW accounts and savings accounts, for example), and will hit a natural floor of close to zero while variable-rate loan yields continue to drop. This effect is exacerbated by the fact that prepayments on fixed-rate loans and mortgage-backed securities tend to increase as rates decline, although rate floors on some of our variable-rate loans partially offset other negative pressures. While we view declining interest rates as highly unlikely, the potential percentage reduction in net interest income slightly exceeds our internal policy guidelines in two of the three declining interest rate scenarios, and we will continue to monitor our interest rate risk profile and take corrective action as appropriate.

If interest rates were to increase by 100 basis points, net interest income would likely improve by $1.329 million, or 2.57%, relative to a stable interest rate scenario. The initial increase in rising rate scenarios is limited to some extent by the fact that many of our variable-rate loans are currently at rate floors, creating a re-pricing lag while variable rates are increasing to floored levels, and is further affected by the impact of certain variable-rate time deposits lifting off of rate floors.

The economic value (or “fair value”) of financial instruments on the Company’s balance sheet will also vary under the interest rate scenarios previously discussed. This variance is essentially a gauge of longer-term exposure to interest rate risk. It is measured by simulating changes in the Company’s economic value of equity (EVE), which is basically derived by subtracting the fair value of liabilities from the fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement interest rates for each account type, while the fair value of non-financial accounts is assumed to equal their book value for all rate scenarios. An economic value simulation is a static measure for balance sheet accounts at a given point in time, and the measurement can change substantially over time as the characteristics of the Company’s balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and management’s best estimates. We have found that model results are highly sensitive to changes in the assumed decay rate for non-maturity deposits, in particular. The table below shows estimated changes in the Company’s EVE as of September 30, 2012, under different interest rate scenarios relative to a base case of current interest rates:

Immediate Change in Rate

	-300 b.p.	-200 b.p.	-100 b.p.	+100 b.p.	+200 b.p.	+300 b.p.
Change in EVE (in $000's)	$-19,215	$-43,006	$-33,692	$+38,980	$+59,923	$+73,467
% Change	-6.15 %	-13.76 %	-10.78 %	+12.47 %	+19.17 %	+23.51 %

The table shows that our EVE will generally deteriorate in declining rate scenarios, but will benefit from rising rates. The changes in EVE are not symmetrical, however, due to the optionality inherent in certain financial instruments. Our EVE profile has changed substantially in recent periods, shifting from unfavorable exposure to a benefit in a rising interest rate environment, due in part to growth in non-maturity deposits and adjustments applied to deposit decay rates and loan prepayment rates in order to better reflect historical patterns. Effectively, lower deposit decay rates mean that we have a longer period to benefit from low-cost deposits, which are even more valuable when the cost of replacing them becomes greater as would be the case in a rising rate environment. However, the same changes that have improved our profile in rising rate scenarios have created greater exposure to declining rates. That negative impact is exacerbated by the acceleration of loan prepayment speeds in declining rate scenarios. While still negative relative to the base case, we see a favorable swing in EVE as interest rates drop from 200 basis points to 300 basis points. This is due to the longer duration of our fixed-rate assets relative to our fixed-rate liabilities, and the resulting impact of a significant rate decline on financial instrument fair values. As noted previously, however, management is of the opinion that the probability of a significant rate decline is low.

CAPITAL RESOURCES

At September 30, 2012, the Company had total shareholders' equity of $174.5 million, comprised of $64.3 million in common stock, $2.4 million in additional paid-in capital, $101.9 million in retained earnings, and $5.9 million in accumulated other comprehensive income. Total shareholders' equity at the end of 2011 was $168.6 million. The increase in shareholders' equity during the first nine months of 2012 was due in large part to the addition of $6.1 million in net earnings, less $2.5 million in dividends paid. Accumulated other comprehensive income, representing the change in the mark-to-market differential of our investment securities (net of the tax impact), also increased by $2.0 million due to increasing market values.

The Company uses a variety of measures to evaluate its capital adequacy, with risk-based capital ratios calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to ensure that they meet or surpass established internal and external guidelines. Refer to Notes to Unaudited Consolidated Financial Statements, Note 13 – Recent Developments, for a summary of changes to risk-based capital calculations which have been proposed by federal banking regulators. The Company and the Bank are both currently classified as "well capitalized," the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. Each of the federal regulators has established risk based and leverage capital guidelines for the bank holding companies or banks it regulates, which set total capital requirements and define capital in terms of "core capital elements," or Tier 1 capital; and "supplemental capital elements," or Tier 2 capital. Tier 1 capital is currently defined as the sum of core capital elements less goodwill and certain other deductions, notably disallowed deferred tax assets and the unrealized net gains or losses (after tax adjustments) on available-for-sale investment securities. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) qualified minority interests in consolidated subsidiaries and similar items; and (iv) qualifying trust preferred securities up to a specified limit. All of the $30 million in junior subordinated debentures on the Company's balance sheet at September 30, 2012 was included in Tier 1 capital; however, if the restrictions proposed under the Notice of Proposed Rulemaking recently issued by our primary regulators are ultimately adopted, the inclusion of these debentures as Tier 1 capital will be phased out.

Tier 2 capital can currently include: (i) the allowance for loan and lease losses plus the reserve for unused commitments (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as Tier 1 capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; (iv) a certain level of unrealized gains on available-for-sale equity securities; and (v) qualifying subordinated debt and redeemable preferred stock (but not more than 50% of Tier 1 capital). Because of the limitation on the allowance for loan and lease losses plus the reserve for unused commitments, $408,000 of the total is currently not includible in Tier 2 capital for Sierra Bancorp's consolidated calculations. The maximum amount of Tier 2 capital that is allowable for risk-based capital purposes is limited to 100% of Tier 1 capital, net of goodwill. The following table sets forth the Company's and the Bank's regulatory capital ratios as of the dates indicated.

Regulatory Capital Ratios

	September 30, 2012		December 31, 2011	
Sierra Bancorp				
Total Capital to Total Risk-weighted Assets	19.96	%	21.72	%
Tier 1 Capital to Total Risk-weighted Assets	18.70	%	20.46	%
Tier 1 Leverage Ratio	13.50	%	14.11	%
Bank of the Sierra				
Total Capital to Total Risk-weighted Assets	19.56	%	20.89	%
Tier 1 Capital to Total Risk-weighted Assets	18.31	%	19.63	%
Tier 1 Leverage Ratio	13.22	%	13.53	%

At the current time, there are no commitments that would necessitate the use of material amounts of the Company’s capital.

PART I – FINANCIAL INFORMATION

Item 3

QUALITATIVE & QUANTITATIVE DISCLOSURES

ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosures about market risk is included in Part I, Item 2 above. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Market Risk Management.”

PART I – FINANCIAL INFORMATION

Item 4

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company’s Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company’s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the “Evaluation Date”) have concluded that as of the Evaluation Date, the Company’s disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this quarterly report was being prepared.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized, and reported within the time periods specified by the SEC.

Changes in Internal Controls

There were no significant changes in the Company’s internal controls over financial reporting that occurred in the third quarter of 2012 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

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PART II - OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial condition or results of operation.

ITEM 1A: RISK FACTORS

There were no material changes from the risk factors disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2011.

ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) Stock Repurchases

The Company's current stock repurchase plan became effective July 1, 2003 and has no expiration date. Of the aggregate 1,250,000 shares authorized for repurchase since the effective date of the plan, there were 100,669 remaining shares available for repurchase as of September 30, 2012. There were no stock repurchases during the third quarter of 2012.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4: (REMOVED AND RESERVED)

Item 5: Other Information

Not applicable

Item 6: Exhibits

Exhibit #	Description
3.1	Restated Articles of Incorporation of Sierra Bancorp (1)
3.2	Amended and Restated By-laws of the Company (2)
10.1	1998 Stock Option Plan (3)
10.2	Salary Continuation Agreement for Kenneth R. Taylor (4)
10.3	Salary Continuation Agreement for James C. Holly (4)
10.4	Salary Continuation Agreement and Split Dollar Agreement for James F. Gardunio (5)
10.5	Split Dollar Agreement for Kenneth R. Taylor (6)
10.6	Split Dollar Agreement and Amendment thereto for James C. Holly (6)
10.7	Director Retirement Agreement and Split dollar Agreement for Vincent Jurkovich (6)
10.8	Director Retirement Agreement and Split dollar Agreement for Robert Fields (6)
10.9	Director Retirement Agreement and Split dollar Agreement for Gordon Woods (6)
10.10	Director Retirement Agreement and Split dollar Agreement for Morris Tharp (6)
10.11	Director Retirement Agreement and Split dollar Agreement for Albert Berra (6)
10.12	401 Plus Non-Qualified Deferred Compensation Plan (6)
10.13	Indenture dated as of March 17, 2004 between U.S. Bank N.A., as Trustee, and Sierra Bancorp, as Issuer (7)
10.14	Amended and Restated Declaration of Trust of Sierra Statutory Trust II, dated as of March 17, 2004 (7)
10.15	Guarantee Agreement between Sierra Bancorp and U.S. Bank National Association dated as of March 17, 2004 (7)
10.16	Indenture dated as of June 15, 2006 between Wilmington Trust Co., as Trustee, and Sierra Bancorp, as Issuer (8)
10.17	Amended and Restated Declaration of Trust of Sierra Capital Trust III, dated as of June 15, 2006 (8)
10.18	Guarantee Agreement between Sierra Bancorp and Wilmington Trust Company dated as of June 15, 2006 (8)
10.19	2007 Stock Incentive Plan (9)
10.20	Sample Retirement Agreement Entered into with Each Non-Employee Director Effective January 1, 2007 (10)
10.21	Salary Continuation Agreement for Kevin J. McPhaill (10)
10.22	First Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (10)
11	Statement of Computation of Per Share Earnings (11)
31.1	Certification of Chief Executive Officer (Section 302 Certification)
31.2	Certification of Chief Financial Officer (Section 302 Certification)
32	Certification of Periodic Financial Report (Section 906 Certification)

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(1) Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.

(2) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.

(3) Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission ("SEC") (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.

(4) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.

(5) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.

(6) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.

(7) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.

(8) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.

(9) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.

(10) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.

(11) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.

SIGNATURES

Pursuant to the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized:

November 8, 2012	/s/ *James C. Holly*
Date	SIERRA BANCORP
	James C. Holly
	President & Chief Executive Officer
	(Principal Executive Officer)

November 8, 2012	/s/ *Kenneth R. Taylor*
Date	SIERRA BANCORP
	Kenneth R. Taylor
	Chief Financial Officer
	(Principal Financial and Principal Accounting Officer)

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