

SIERRA BANCORP  
Form 10-Q  
November 08, 2012

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012

Commission file number: 000-33063

**Sierra Bancorp**

(Exact name of Registrant as specified in its charter)

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

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

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  R                      No  £

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  R                      No  £

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  £                      No  R

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

Common stock, no par value, 14,106,889 shares outstanding as of October 31, 2012

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**PART I - FINANCIAL INFORMATION****Item 1 – Financial Statements****SIERRA BANCORP****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

	September 30, 2012 (unaudited)	December 31, 2011 (audited)
<b>ASSETS</b>		
Cash and due from banks	\$ 41,744	\$ 42,805
Interest-bearing deposits in banks	3,351	20,231
Total Cash & Cash Equivalents	45,095	63,036
Investment securities available for sale	414,635	406,471
Loans held for sale	618	1,354
Loans and leases:		
Gross loans and leases	847,130	757,591
Allowance for loan and lease losses	(12,806)	(17,283)
Deferred loan and lease fees, net	926	621
Net Loans and Leases	835,250	740,929
Premises and equipment, net	22,218	20,721
Operating leases, net	268	384
Foreclosed assets	19,835	15,364
Goodwill	5,544	5,544
Other assets	79,839	81,602
<b>TOTAL ASSETS</b>	<b>\$ 1,423,302</b>	<b>\$ 1,335,405</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 323,184	\$ 300,045
Interest bearing	822,669	786,223
Total Deposits	1,145,853	1,086,268
Federal funds purchased and repurchase agreements	3,634	3,037
Short-term borrowings	47,900	17,120
Long-term borrowings	5,000	15,000
Junior subordinated debentures	30,928	30,928
Other liabilities	15,514	14,488
<b>TOTAL LIABILITIES</b>	<b>1,248,829</b>	<b>1,166,841</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common stock, no par value; 24,000,000 shares		

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authorized; 14,103,849 and 14,101,609 shares issued  
and outstanding at September 30, 2012 and  
December 31, 2011, respectively

Additional paid in capital	64,344	64,321
Retained earnings	2,364	2,221
Accumulated other comprehensive income	101,877	98,174
TOTAL SHAREHOLDERS' EQUITY	5,888	3,848
	174,473	168,564
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,423,302	\$ 1,335,405

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

**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF INCOME**

(dollars in thousands, except per share data, unaudited)

	Three Months Ended September		Nine Months Ended September	
	30,	2011	30,	2011
	2012		2012	
Interest income:				
Interest and fees on loans	\$ 11,954	\$ 11,780	\$ 34,251	\$ 35,480
Interest on investment securities:				
Taxable	1,523	2,420	5,159	6,621
Tax-exempt	700	716	2,052	2,153
Interest on federal funds sold and interest-bearing deposits	15	23	51	56
Total interest income	14,192	14,939	41,513	44,310
Interest expense:				
Interest on deposits	796	1,063	2,490	3,279
Interest on short-term borrowings	23	7	41	46
Interest on long-term borrowings	51	143	231	425
Interest on mandatorily redeemable trust preferred securities	193	179	586	540
Total interest expense	1,063	1,392	3,348	4,290
Net Interest Income	13,129	13,547	38,165	40,020
Provision for loan losses	4,700	3,000	10,610	9,600
Net Interest Income after Provision for Loan Losses	8,429	10,547	27,555	30,420
Non-interest revenue:				
Service charges on deposit accounts	2,525	2,439	7,229	7,140
Gains on investment securities available-for-sale	90	-	161	-
Other income, net	1,281	930	4,831	3,278
Total other operating income	3,896	3,369	12,221	10,418
Other operating expense:				
Salaries and employee benefits	5,278	4,849	15,855	15,760
Occupancy expense	1,669	1,787	4,721	4,987
Other	4,064	3,932	13,059	13,078
Total other operating expenses	11,011	10,568	33,635	33,825

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Income before income taxes	1,314	3,348	6,141	7,013
Provision for income taxes	(321	) 822	54	774
Net Income	\$ 1,635	\$ 2,526	\$ 6,087	\$ 6,239
PER SHARE DATA				
Book value	\$ 12.37	\$ 11.97	\$ 12.37	\$ 11.97
Cash dividends	\$ 0.06	\$ 0.06	\$ 0.18	\$ 0.18
Earnings per share basic	\$ 0.12	\$ 0.18	\$ 0.43	\$ 0.45
Earnings per share diluted	\$ 0.12	\$ 0.18	\$ 0.43	\$ 0.44
Average shares outstanding, basic	14,103,543	14,051,614	14,102,880	14,015,583
Average shares outstanding, diluted	14,138,682	14,097,368	14,114,962	14,081,936
Total shareholder Equity (in thousands)	\$ 174,473	\$ 168,325	\$ 174,473	\$ 168,325
Shares outstanding	14,103,849	14,062,259	14,103,849	14,062,259
Dividends Paid	\$ 846,193	\$ 842,800	\$ 2,538,482	\$ 2,521,643

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



**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in thousands, unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net Income	\$ 1,635	\$ 2,526	\$ 6,087	\$ 6,239
Other comprehensive income, before tax:				
Unrealized gains on securities:				
Unrealized holding gains arising during period	1,926	1,838	3,635	7,127
Less: reclassification adjustment for gains included in net income	(90 )	-	(161 )	-
Other comprehensive income, before tax	1,836	1,838	3,474	7,127
Income tax expense related to items of other comprehensive income, net of tax	(756 )	765	(1,434 )	2,928
Other comprehensive income	1,080	1,073	2,040	4,199
Comprehensive income	\$ 2,715	\$ 3,599	\$ 8,127	\$ 10,438

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

**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in thousands, unaudited)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 6,087	\$ 6,239
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on investment of securities	(161	) -
Gain on sales of loans	(139	) (93
Loss (Gain) on disposal of fixed assets	10	(12
Loss on sale on foreclosed assets	709	569
Writedowns on foreclosed assets	1,610	1,656
Share-based compensation expense	183	166
Provision for loan losses	10,610	9,600
Depreciation and amortization	1,813	1,971
Net amortization on securities premiums and discounts	6,214	4,031
Increase in unearned net loan fees	(304	) (291
Increase in cash surrender value of life insurance policies	(30	) (5,538
Proceeds from sales of loans portfolio	5,717	3,440
Net (Increase) Decrease in loans held-for-sale	(4,842	) 59
(Increase) Decrease in interest receivable and other assets	(677	) 1,362
Increase (Decrease) in other liabilities	1,179	(389
Net Decrease in FHLB Stock	670	996
Deferred Income Tax Provision (Benefit)	318	(105
Excess tax (provision) benefit from equity based compensation	(39	) 4
Net cash provided by operating activities	28,928	23,665
Cash flows from investing activities:		
Maturities of securities available for sale	1,080	2,664
Proceeds from sales/calls of securities available for sale	11,319	3,119
Purchases of securities available for sale	(99,084	) (154,229
Principal pay downs on securities available for sale	75,953	53,430
Net (Increase) Decrease in loans receivable, net	(125,316	) 28,709
Purchases of premises and equipment, net	(3,204	) (830
Proceeds from sales of foreclosed assets	13,898	4,681
Net cash used in investing activities	(125,354	) (62,456
Cash flows from financing activities:		
Increase in deposits	59,585	41,345
Increase in borrowed funds	20,780	10,350
Increase in repurchase agreements	597	4,633
Cash dividends paid	(2,538	) (2,522

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Repurchases of common stock	-	(23	)
Stock options exercised	22	672	
Excess tax provision (benefit) from equity based compensation	39	(4	)
Net cash provided by financing activities	78,485	54,451	
 (Decrease) Increase in cash and due from banks	 (17,941	 )	 15,660
 Cash and Cash Equivalents			
Beginning of period	63,036	42,645	
End of period	\$ 45,095	\$ 58,305	

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

Sierra Bancorp

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

September 30, 2012

**Note 1 – The Business of Sierra Bancorp**

Sierra Bancorp (the “Company”) is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the “Bank”), and has been the Bank’s sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company’s only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities (TRUPS). Pursuant to the Financial Accounting Standards Board’s (FASB’s) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the “Company” include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. Our branch footprint stretches from Fresno on the north to Bakersfield on the south, and on the southern end extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. We currently operate 25 full service branch offices throughout our geographic footprint, as well as an internet branch which provides the ability to open deposit accounts online. The Bank’s most recent branch expansion activity includes a new branch which opened for business in the city of Selma in February 2011, and the relocation of our Clovis branch to a larger facility in a more convenient location in the third quarter of 2012. In addition to our full-service branches, the Bank has an agricultural credit division with lending staff domiciled in Porterville, Bakersfield and Visalia, an SBA lending unit located at our corporate headquarters, and offsite ATM’s at six different non-branch locations. The Bank’s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

**Note 2 – Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles

(GAAP) for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. In preparing the accompanying consolidated financial statements, management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2011 have been reclassified to be consistent with the reporting for 2012. The interim financial information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission.

### **Note 3 – Current Accounting Developments**

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

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

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

#### **Note 4 – Supplemental Disclosure of Cash Flow Information**

During the nine months ended September 30, 2012 and 2011, cash paid for interest due on interest-bearing liabilities was \$3.087 million and \$3.991 million, respectively. There was no cash paid for income taxes during the nine months

ended September 30, 2012, and \$1.643 million for the same time frame in 2011. Assets totaling \$20.724 million and \$4.663 million were acquired in settlement of loans for the nine months ended September 30, 2012 and September 30, 2011, respectively. We received \$10.134 million in cash from the sale of foreclosed assets during the first nine months of 2012 relative to \$2.779 million during the first nine months of 2011, which represents sales proceeds less loans extended to finance such sales totaling \$3.735 million for the first nine months of 2012 and \$1.506 million for the first nine months of 2011.

**Note 5 – Share Based Compensation**

The 2007 Stock Incentive Plan (the “2007 Plan”) was adopted by the Company in 2007. Our 1998 Stock Option Plan (the “1998 Plan”) was concurrently terminated, although options to purchase 171,550 shares that were granted prior to the termination of the 1998 Plan were still outstanding as of September 30, 2012 and remain unaffected by the termination. The 2007 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of “nonqualified” stock options to non-employee directors of the Company. The 2007 Plan also provides for the potential issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company’s authorized but unissued stock reserved for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although options have been granted since the inception of the plan and the number remaining available for grant as of September 30, 2012 was 911,640. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share. No restricted stock awards have been issued by the Company.

Pursuant to FASB’s standards on stock compensation, the value of each option granted is reflected in our income statement as share-based compensation expense or directors’ expense, by amortizing it over the vesting period of such option or by expensing it as of the grant date for immediately vested options. The Company is utilizing the Black-Scholes model to value stock options, and the “multiple option” approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee’s options for each vesting period are separately valued and amortized. This appears to be the preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of \$61,000 was reflected in the Company’s income statement during the third quarter of 2012 and \$48,000 was charged during the third quarter of 2011, as expense related to stock options. For the first nine months, the charges amounted to \$183,000 in 2012 and \$166,000 in 2011.

**Note 6 – Earnings per Share**

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 14,103,543 weighted average shares outstanding during the third quarter of 2012, and 14,051,614 during the third quarter of 2011. There were 14,102,880 weighted average shares outstanding during the first nine months of 2012, and 14,015,583 during the first nine months of 2011.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of “in-the-money” stock options. The dilutive effect of options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the third quarter and first nine months of 2012, the dilutive effect



of options outstanding calculated under the treasury stock method totaled 35,139 and 12,082, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the third quarter and first nine months of 2011 shares totaling 45,754 and 66,353, respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 – Comprehensive Income

Comprehensive income, as presented in the Consolidated Statements of Comprehensive Income, includes net income and other comprehensive income. The Company's only source of other comprehensive income is unrealized gains and losses on available-for-sale investment securities. Gains or losses on investment securities that were realized and included in net income of the current period, which had previously been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are considered to be reclassification adjustments that are excluded from comprehensive income of the current period.

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

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

	September 30, 2012	December 31, 2011
Commitments to extend credit	\$ 239,849	\$ 154,323
Standby letters of credit	\$ 6,059	\$ 11,113
Commercial letters of credit	\$ 8,543	\$ 8,991

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

The Company is also utilizing a \$74 million letter of credit issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits. The letter of credit is backed by specific loans which are pledged to the Federal Home Loan Bank by the Company.

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

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

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

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

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

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

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized gains and losses could have a significant effect on fair value estimates but have not been considered in any estimates. Because no market exists for a significant portion of the Company's financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments disclosed at September 30, 2012 and December 31, 2011:

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

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

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

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

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

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

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

Other investments: Certain long-term investments for which no secondary market exists are carried at cost, and the carrying amount for those investments approximates their estimated fair value.

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

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

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

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

Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would approximate fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

Estimated fair values for the Company's financial instruments at the periods noted are as follows:

**Fair Value of Financial Instruments**

(dollars in thousands, unaudited)

September 30, 2012

Estimated Fair Value

Quoted

Prices in

Active

Significant

Significant

Carrying

Markets

Observable

Unobservable

Total

for

Inputs

Inputs

Identical

(Level 2)

(Level 3)

Assets

(Level 1)

(Dollars in thousands)

Financial Assets:

Cash and cash equivalents	\$45,095	\$45,095	\$ -	\$ -	\$45,095
Investment securities available for sale	414,635	1,911	412,724	-	414,635
Loans and leases, net	823,850	-	867,484	-	867,484
Collateral dependent impaired loans	11,401	-	9,044	-	9,044
Loans held-for-sale	618	618	-	-	618
Cash surrender value of life insurance policies	37,687	-	37,687	-	37,687
Other investments	6,370	-	6,370	-	6,370
Investment in Limited Partnership	10,537	-	10,537	-	10,537
Accrued interest receivable	5,228	-	5,228	-	5,228

Financial Liabilities:

Deposits:

Noninterest-bearing	\$323,184	\$323,184	\$ -	\$ -	\$323,184
Interest-bearing	822,669	-	745,132	-	745,132
Fed Funds Purchased and Repurchase Agreements	3,634	-	3,634	-	3,634
Short-term borrowings	47,900	-	47,900	-	47,900
Long-term borrowings	5,000	-	5,084	-	5,084
Subordinated debentures	30,928	-	12,141	-	12,141
Limited partnership capital commitment	1,138	-	1,138	-	1,138
Accrued Interest Payable	252	-	252	-	252

Notional  
Amount

Off-balance-sheet financial instruments:

Commitments to extend credit	\$239,849
Standby letters of credit	6,059
Commercial lines of credit	8,543

December 31, 2011

Estimated Fair Value

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	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1) (Dollars in thousands)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
<b>Financial Assets:</b>					
Cash and cash equivalents	\$63,036	\$63,036	\$ -	\$ -	\$63,036
Investment securities available for sale	406,471	1,347	405,124	-	406,471
Loans and leases, net	726,302	-	771,192	-	771,192
Collateral dependent impaired loans	14,627	-	11,016	285	11,301
Loans held-for-sale	1,354	1,354	-	-	1,354
Cash surrender value of life insurance policies	37,657	-	37,657	-	37,657
Other Investments	7,040	-	7,040	-	7,040
Investment in Limited Partnership	9,927	-	9,927	-	9,927
Accrued Interest Receivable	5,368	-	5,368	-	5,368
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Noninterest-bearing	\$300,045	\$300,045	\$ -	\$ -	\$300,045
Interest-bearing	786,223	-	702,270	-	702,270
Fed Funds Purchased and Repurchase Agreements	3,037	-	3,037	-	3,037
Short-term borrowings	17,120	-	17,120	-	17,120
Long-term borrowings	15,000	-	15,000	-	15,000
Subordinated debentures	30,928	-	12,262	-	12,262
Limited partnership capital commitment	353	-	353	-	353
Accrued Interest Payable	514	-	514	-	514
		Notional Amount			
<b>Off-balance-sheet financial instruments:</b>					
Commitments to extend credit	\$154,323				
Standby letters of credit	11,113				
Commercial lines of credit	8,991				



For each financial asset category that was actually reported at fair value at September 30, 2012 and December 31, 2011, the Company used the following methods and significant assumptions:

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

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

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

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

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

Fair Value Measurements - Recurring

(dollars in thousands, unaudited)

	Fair Value Measurements at September 30, 2012, Using Quoted Prices in				Realized Gain/(Loss)
	Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	
Investment Securities					
U.S. Government agencies	\$-	\$ 1,134	\$ -	\$ 1,134	\$ -
Obligations of states and political subdivisions	-	80,963	-	80,963	-
U.S. Government agencies collateralized by mortgage obligations	-	330,627	-	330,627	-
Other Securities	1,911	-	-	1,911	-
Total available-for-sale securities	\$ 1,911	\$ 412,724	\$ -	\$ 414,635	\$ -

	Fair Value Measurements at December 31, 2011, Using Quoted Prices in				Realized Gain/(Loss)
	Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	
Investment Securities					
U.S. Government agencies	\$-	\$ 2,026	\$ -	\$ 2,026	\$ -
Obligations of states and political subdivisions	-	71,340	-	71,340	-
U.S. Government agencies collateralized by mortgage obligations	-	331,758	-	331,758	-
Other Securities	1,347	-	-	1,347	(1,370 )
Total available-for-sale securities	\$ 1,347	\$ 405,124	\$ -	\$ 406,471	\$ (1,370 )



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

Fair Value Measurements - Nonrecurring

(dollars in thousands, unaudited)

	Fair Value Measurements at September 30, 2012, Using			
	Quoted Prices in Active Markets for Identifiable Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Collateral Dependent Impaired Loans	\$- \$ 9,044	\$ -	\$ -	\$9,044
Foreclosed Assets	\$- \$ 19,835	\$ -	\$ -	\$19,835

	Fair Value Measurements at December 31, 2011, Using			
	Quoted Prices in Active Markets for Identifiable Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Collateral Dependent Impaired Loans	\$- \$ 11,016	\$ 285	\$ -	\$11,301
Foreclosed Assets	\$- \$ 14,777	\$ 587	\$ -	\$15,364

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

The unobservable inputs are based on management's best estimates of appropriate discounts in arriving at fair market value. Significant increases or decreases in any of those inputs could result in a significantly lower or higher fair value measurement. For example, a change in either direction of actual loss rates would have a directionally opposite change in the calculation of the fair value of impaired unsecured loans.

**Note 10 – Investments**

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB's guidance on accounting for debt and equity securities, available for sale securities are carried on the Company's financial statements at their estimated fair market values, with monthly tax-effected "mark-to-market" adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity. The Company's available-for-sale investment securities totaled \$415 million at September 30, 2012, and \$406 million at December 31, 2011.

**Amortized Cost And Estimated Fair Value**

The amortized cost and estimated fair value of investment securities available-for-sale are as follows

(Dollars in thousands, unaudited):

	September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	\$1,129	\$ 5	\$ -	\$1,134
Obligations of state and political subdivisions	76,558	4,480	(75 )	80,963
U.S. Government agencies collateralized by mortgage obligations	325,605	5,763	(741 )	330,627
Equity Securities	1,336	575	-	1,911
	\$404,628	\$ 10,823	\$ (816 )	\$414,635

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	\$2,008	\$ 18	\$ -	\$2,026
Obligations of state and political subdivisions	67,851	3,634	(145 )	71,340
U.S. Government agencies collateralized by mortgage obligations	328,751	4,467	(1,460 )	331,758
Equity Securities	1,336	11	-	1,347
	\$399,946	\$ 8,130	\$ (1,605 )	\$406,471

At September 30, 2012 and December 31, 2011, the Company had 76 securities and 80 securities, respectively, with unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the associated unrealized losses are other than temporary. Information pertaining to our investment securities with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous loss position, is disclosed in the table below.

Investment Portfolio - Unrealized Losses

(dollars in thousands, unaudited)

	September 30, 2012			
	Less than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Government Agencies	\$-	\$-	\$-	\$-
Obligations of State and Political Subdivisions	(75 )	5,881	-	-
U.S. Government agencies collateralized by mortgage obligations	(591)	90,344	(150)	14,363
<b>TOTAL</b>	<b>\$(666)</b>	<b>\$96,225</b>	<b>\$(150)</b>	<b>\$14,363</b>

	December 31, 2011			
	Less than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
Obligations of State and Political Subdivisions	\$(26 )	\$1,735	\$(119)	\$1,978
U.S. Government agencies collateralized by mortgage obligations	(1,432)	144,953	(28 )	949
<b>TOTAL</b>	<b>\$(1,458)</b>	<b>\$146,688</b>	<b>\$(147)</b>	<b>\$2,927</b>

Note 11 – Credit Quality and Nonperforming Assets

**Credit Quality Classifications**

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

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

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

Substandard: Loans classified as substandard have at least one clear and well-defined weakness which could jeopardize the ultimate recoverability of all principal and interest, such as a borrower displaying a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or a deteriorated financial condition.

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



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

Credit Quality Classifications

(dollars in thousands, unaudited)

	September 30, 2012				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 Family residential construction	\$2,004	\$3,450	\$ -	\$ 1,558	\$7,012
Other construction/Land	19,771	3,191	3,693	8,289	34,944
1-4 Family - closed-end	75,048	6,487	736	19,329	101,600
Equity Lines	58,527	23	1,931	1,411	61,892
Multi-family residential	4,590	611	-	-	5,201
Commercial real estate - owner occupied	137,460	21,838	5,786	10,083	175,167
Commercial real estate - non-owner occupied	64,770	7,642	540	18,863	91,815
Farmland	55,523	916	3,552	1,943	61,934
Total Real Estate	417,693	44,158	16,238	61,476	539,565
Agricultural	19,915	30	25	999	20,969
Commercial and Industrial	221,773	4,166	2,973	2,242	231,154
Small Business Administration	14,511	1,671	624	3,422	20,228
Direct finance leases	4,515	38	-	190	4,743
Consumer loans	25,254	603	224	4,390	30,471
Total Gross Loans and Leases	\$703,661	\$50,666	\$ 20,084	\$ 72,719	\$847,130
	December 31, 2011				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 Family residential construction	\$4,240	\$2,004	\$ -	\$ 2,244	\$8,488
Other construction/Land	18,185	8,873	1,015	11,987	40,060
1-4 Family - closed-end	75,765	7,574	1,354	20,260	104,953
Equity Lines	62,867	456	1,795	1,379	66,497
Multi-family residential	4,620	618	-	2,941	8,179
Commercial real estate - owner occupied	141,245	23,289	8,878	9,658	183,070
Commercial real estate - non-owner occupied	64,746	7,463	4,514	29,120	105,843
Farmland	47,719	1,878	3,626	6,919	60,142
Total Real Estate	419,387	52,155	21,182	84,508	577,232
Agricultural	15,477	1,574	27	-	17,078
Commercial and Industrial	83,780	7,529	3,078	5,021	99,408
Small Business Administration	16,251	-	852	3,903	21,006
Direct finance leases	6,089	63	-	591	6,743
Consumer loans	30,004	1,006	808	4,306	36,124
Total Gross Loans and Leases	\$570,988	\$62,327	\$ 25,947	\$ 98,329	\$757,591



**Past Due and Nonperforming Assets**

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

**Loan Portfolio Aging**

(dollars in thousands, unaudited)

	September 30, 2012							
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans <sup>(1)</sup>	
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	

<sup>(1)</sup> Included in Total Financing Receivables

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	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due <sup>(2)</sup>	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans <sup>(1)</sup>
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

<sup>(1)</sup> Included in Total Financing Receivables

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

**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
Troubled 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

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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

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 <sup>(1)</sup>	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

<sup>(1)</sup> 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 <sup>(1)</sup>	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

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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

<sup>(1)</sup> 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.



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<sup>(1)</sup>**

(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

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



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.

<u>Impaired Loans</u>	September 30, 2012				
(dollars in thousands, unaudited)	Unpaid Principal Balance <sup>(1)</sup>	Recorded Investment <sup>(2)</sup>	Related Allowance	Average Recorded Investment	Interest Income Recognized <sup>(3)</sup>
<b>With an Allowance Recorded</b>					
<b>Real Estate:</b>					
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	-
<b>Total Real Estate</b>	<b>23,141</b>	<b>23,141</b>	<b>3,244</b>	<b>23,726</b>	<b>602</b>
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
<b>With no Related Allowance Recorded</b>					
<b>Real Estate:</b>					
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

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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

<sup>(1)</sup>Contractual principal balance due from customer.

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

<sup>(3)</sup>Interest income is recognized on performing balances on a regular accrual basis.

<u>Impaired Loans</u>	December 31, 2011			
(dollars in thousands, unaudited)	Unpaid Recorded Principal Investment <sup>(1)</sup> Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized <sup>(3)</sup>
With an Allowance Recorded				