UNITED SECURITY BANCSHARES
Form 10-Q
November 12, 2013
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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2013
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number: 000-32897

UNITED SECURITY BANCSHARES
(Exact name of registrant as specified in its charter)

CALIFORNIA (State or other jurisdiction of incorporation or organization)	91-2112732 (I.R.S. Employer Identification No.)
2126 Inyo Street, Fresno, California (Address of principal executive offices)	93721 (Zip Code)

Registrants telephone number, including area code (559) 248-4943

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

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 for the past 90 days. Yes x 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).
Large accelerated filer o Accelerated filer o Non-accelerated filer o Small reporting company x

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

Aggregate market value of the Common Stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter - June 30, 2013: $43,148,493

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
(Title of Class)

Shares outstanding as of October 31, 2013: 14,653,336

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PART I. Financial Information

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets – (unaudited)
September 30, 2013 and December 31, 2012

(in thousands except shares)	September 30, 2013	December 31, 2012
Assets		
Cash and due from banks	$28,552	$27,481
Cash and due from FRB	153,290	114,146
Cash and cash equivalents	181,842	141,627
Interest-bearing deposits in other banks	1,513	1,507
Investment securities available for sale (at fair value)	32,577	31,844
Loans and leases	384,030	400,057
Unearned fees and unamortized loan origination costs	(38)	(24)
Allowance for credit losses	(10,552)	(11,784)
Net loans	373,440	388,249
Accrued interest receivable	1,397	1,694
Premises and equipment – net	12,088	12,262
Other real estate owned	17,125	23,932
Intangible assets	109	249
Goodwill	4,488	4,488
Cash surrender value of life insurance	17,072	16,681
Investment in limited partnerships	4,018	4,312
Deferred income taxes - net	10,130	9,724
Other assets	5,932	12,308
Total assets	$661,731	$648,877
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$236,112	$217,014
Interest bearing	335,364	346,273
Total deposits	571,476	563,287
Accrued interest payable	57	71
Accounts payable and other liabilities	5,895	6,010
Junior subordinated debentures (at fair value)	10,804	10,068
Total liabilities	588,232	579,436
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 14,653,336 issued and outstanding at September 30, 2013, and 14,217,303 at December 31, 2012	45,038	43,173
Retained earnings	28,662	26,179
Accumulated other comprehensive (loss) income	(201)	89
Total shareholders' equity	73,499	69,441
Total liabilities and shareholders' equity	$661,731	$648,877

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United Security Bancshares and Subsidiaries
Consolidated Statements of Operations
(Unaudited)

	Quarter Ended September 30,		Nine Months Ended September 30,	
(In thousands except shares and EPS)	2013	2012	2013	2012
Interest Income:				
Loans, including fees	$5,545	$5,670	$16,565	$17,678
Investment securities – AFS – taxable	157	397	495	1,375
Interest on deposits in FRB	88	62	223	157
Interest on deposits in other banks	2	2	6	22
Total interest income	5,792	6,131	17,289	19,232
Interest Expense:				
Interest on deposits	301	441	1,043	1,356
Interest on other borrowings	64	68	217	207
Total interest expense	365	509	1,260	1,563
Net Interest Income Before Provision for Credit Losses	5,427	5,622	16,029	17,669
Provision for Credit Losses	(1,150)	4	(1,120)	1,010
Net Interest Income	6,577	5,618	17,149	16,659
Noninterest Income:				
Customer service fees	873	902	2,554	2,700
Increase in cash surrender value of bank-owned life insurance	140	147	417	427
Loss on sale of securities	—	(10)	—	(10)
Impairment loss on investment securities	—	(113)	—	(284)
(Loss) gain on fair value of financial liability	141	(171)	(519)	(284)
Gain on sale of other investment	—	—	—	1,807
Other	259	218	586	599
Total noninterest income	1,413	973	3,038	4,955
Noninterest Expense:				
Salaries and employee benefits	2,210	2,078	6,684	6,676
Occupancy expense	905	1,004	2,693	2,608
Data processing	33	15	126	53
Professional fees	316	408	1,136	1,092
Regulatory assessments	334	275	1,032	1,058
Director fees	58	61	175	196
Amortization of intangibles	47	79	140	248
Correspondent bank service charges	72	75	229	235
Loss on California tax credit partnership	86	23	151	207
Net cost (gain) on operation and sale of OREO	182	(91)	(1,036)	238
Other	711	520	1,851	1,722
Total noninterest expense	4,954	4,447	13,181	14,333
Income Before Provision for Taxes	3,036	2,144	7,006	7,281
Provision for Taxes on Income	1,184	778	2,683	2,690
Net Income	$1,852	$1,366	$4,323	$4,591
Net Income per common share				
Basic	$0.13	$0.09	$0.30	$0.32
Diluted	$0.13	$0.09	$0.30	$0.32

Shares on which net income per common shares were based				
Basic	14,653,336	14,507,796	14,650,992	14,507,796
Diluted	14,653,570	14,507,796	14,651,915	14,507,796

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United Security Bancshares and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Net Income	$1,852	$1,366	$4,323	$4,591
Unrealized holdings gains (losses) on securities	(127)	811	(542)	1,494
Unrealized gains on unrecognized post retirement costs	20	—	60	—
Other comprehensive (loss) income, before tax	(107)	811	(482)	1,494
Tax benefit (expense) related to securities	50	(324)	217	(597)
Tax expense related to unrecognized post retirement costs	(8)	—	(25)	—
Total other comprehensive (loss) income	(65)	487	(290)	897
Comprehensive income	$1,787	$1,853	$4,033	$5,488

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United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
(unaudited)

	Common stock				
(In thousands except shares)	Number of Shares	Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance December 31, 2011	13,531,832	$41,435	$21,447	$ (709)	$62,173
Other comprehensive (loss) income				897	897
Common stock dividends	409,985	984	(984)		0
Stock-based compensation expense		13			13
Net Income			4,591		4,591
Balance September 30, 2012	13,941,817	$42,432	$25,054	$ 188	$67,674
Other comprehensive (loss) income				(99)	(99)
Common stock dividends	140,725	353	(353)		
Common stock issuance	134,761	383			383
Stock-based compensation expense		5			5
Net Income			1,478		1,478
Balance December 31, 2012	14,217,303	$43,173	$26,179	$ 89	$69,441
Other comprehensive (loss) income				(290)	(290)
Common stock dividends	430,831	1,840	(1,840)		0
Stock options exercised	5,202	12			12
Stock-based compensation expense		13			13
Net Income			4,323		4,323
Balance September 30, 2013	14,653,336	$45,038	$28,662	$ (201)	$73,499

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United Security Bancshares and Subsidiaries
Consolidated Statements of Cash Flows (unaudited)

	Nine Months Ended September 30,	
(In thousands)	2013	2012
Cash Flows From Operating Activities:		
Net Income	$4,323	$4,591
Adjustments to reconcile net income:to cash provided by operating activities:		
Provision for credit losses	(1,120)	1,010
Depreciation and amortization	967	923
Amortization of investment securities	20	24
Accretion of investment securities	(49)	(150)
Decrease in accrued interest receivable	297	326
Decrease in accrued interest payable	(14)	(17)
Increase (decrease) in accounts payable and accrued liabilities	156	(66)
Increase (decrease) in unearned fees	14	(182)
Increase in income taxes payable	6,575	2,754
Stock-based compensation expense	13	13
Deferred income taxes	272	25
Gain on sale of other real estate owned	(1,949)	(386)
Impairment loss on other real estate owned	214	—
Impairment loss on investment securities	—	284
Impairment loss on investment in bank stock	—	76
Increase in surrender value of life insurance	(442)	(427)
Loss on fair value option of financial liabilities	519	284
Loss on tax credit limited partnership interest	151	207
Amortization of Goodwill and CDI	140	248
Loss on sale of investment securities	—	10
Gain on sale of other investment	—	(1,807)
Net decrease in other assets	(920)	(263)
Net cash provided by operating activities	9,167	7,477
Cash Flows From Investing Activities:		
Net (increase) decrease in interest-bearing deposits with banks	(6)	681
Redemption of correspondent bank stock	433	438
Purchases of available-for-sale securities	(8,302)	(11,022)
Maturities and calls of available-for-sale securities	3,600	3,508
Principal payments of available-for-sale securities	3,458	5,088
SERP distributions	—	(31)
Net decrease in loans	17,806	29,139
Cash proceeds from sales of other real estate owned	6,651	3,988
Cash proceeds from sale of other investment	—	2,174
Cash proceeds from sale of premises and equipment	—	36
Capital expenditures for premises and equipment	(793)	(769)
Net cash provided by investing activities	22,847	33,230

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Cash Flows From Financing Activities:		
Net increase in demand deposits and savings accounts	16,372	10,752
Net decrease in certificates of deposit	(8,183)	(34,123)
Proceeds from exercise of stock options	12	—
Net cash provided by (used in) financing activities	8,201	(23,371)
Net increase in cash and cash equivalents	40,215	17,336
Cash and cash equivalents at beginning of period	141,627	124,184
Cash and cash equivalents at end of period	$181,842	$141,520

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United Security Bancshares and Subsidiaries - Notes to Consolidated Financial Statements - (Unaudited)

1. Organization and Summary of Significant Accounting and Reporting Policies

The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary United Security Bank (the "Bank") and two bank subsidiaries, USB Investment Trust (the "REIT") and United Security Emerging Capital Fund, (collectively the "Company" or "USB"). Intercompany accounts and transactions have been eliminated in consolidation.

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2012 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Certain reclassifications have been made to the 2012 financial statements to conform to the classifications used in 2013.

Recently Issued Accounting Standards:

In February 2013, The Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, to improve the transparency of reporting reclassifications out of accumulated other comprehensive income. ASU 2013-02 requires an organization to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income–but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for reporting periods beginning after December 15, 2012. The amounts reclassified out of net income were not significant and this ASU did not have a significant impact on the Company's financial statements.

In January 2013, the FASB issued ASU No. 2013-01 Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, which clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. It further clarifies that the scope of ASU No. 2011-11 applies to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in FASB Accounting Standards Codification® or subject to a master netting arrangement or similar agreement. Both ASU 2011-11 and ASU 2013-1 are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company adopted these ASUs during the first quarter of 2013 and they did not have a material impact on its financial statements.

In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. The ASU enhances disclosures in order to improve the comparability of offsetting (netting) assets and liabilities reported in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) by requiring entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the statements of condition and instruments and transactions subject to an agreement similar to a master netting arrangement. This ASU did not have a significant impact on the Company's financial statements.

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2. Investment Securities Available for Sale and Other Investments

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of September 30, 2013 and December 31, 2012:

(In thousands) September 30, 2013 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$25,803	$675	$(7)	$26,471
U.S. Government collateralized mortgage obligations	2,172	147	—	2,319
Mutual Funds	4,000	—	(213)	3,787
Total securities available for sale	$31,975	$822	$(220)	$32,577

December 31, 2012 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$23,433	$933	$—	$24,366
U.S. Government collateralized mortgage obligations	3,266	251	—	3,517
Mutual Funds	4,000	—	(39)	3,961
Total securities available for sale	$30,699	$1,184	$(39)	$31,844

The amortized cost and fair value of securities available for sale at September 30, 2013, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

	September 30, 2013	
(In thousands)	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	$4,023	$3,811
Due after one year through five years	12,234	12,271
Due after five years through ten years	1,924	2,066
Due after ten years	11,622	12,110
Collateralized mortgage obligations	2,172	2,319
	$31,975	$32,577

There were no realized gains or losses on sale of available-for-sale securities for the nine months ended September 30, 2013, compared to a $10,000 realized loss on sale of available-for sale securities for the same period ended September 30, 2012. There were no other-than-temporary impairment losses for the three and nine months ended September 30, 2013. There were other-than-temporary impairment losses on certain of the Company’s private label mortgage-backed securities of $113,000 and $284,000 for the three and nine months ended September 30, 2012.

At September 30, 2013 available-for-sale securities with an amortized cost of approximately $19,688,000 (fair value of $20,489,000) were pledged as collateral for FHLB borrowings and public funds balances.

The Company had no held-to-maturity or trading securities at September 30, 2013 or December 31, 2012.

Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other-than-temporary.

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The following summarizes temporarily impaired investment securities:

(In thousands)	Less than 12 Months		12 Months or More		Total	
September 30, 2013 Securities available for sale:	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
U.S. Government agencies	$6,303	$(7)	$—	$—	$6,303	$(7)
U.S. Government agency collateral mortgage obligations	—	—	—	—	—	—
Mutual Funds	3,787	(213)	—	—	3,787	(213)
Total impaired securities	$10,090	$(220)	$—	$—	$10,090	$(220)
December 31, 2012: Securities available for sale:						
U.S. Government agencies	$—	$—	$—	$—	$—	$—
U.S. Government agency collateral mortgage obligations	—	—	—	—	—	—
Mutual Funds	3,961	(39)	—	—	3,961	(39)
Total impaired securities	$3,961	$(39)	$—	$—	$3,961	$(39)

The Company evaluates investment securities for other-than-temporary impairment (OTTI) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, Investments – Debt and Equity Instruments. Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated under ASC Topic 325-40, Beneficial Interest in Securitized Financial Assets.

In the first segment, the Company considers many factors in determining OTTI, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to the Company at the time of the evaluation.

The second segment of the portfolio uses the OTTI guidance that is specific to purchased beneficial interests including private label mortgage-backed securities. Under this model, the Company compares the present value of the remaining

cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

Other-than-temporary-impairment occurs when the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary-impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary-impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary-impairment related to the credit

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loss is recognized in earnings, and is determined based on the difference between the present value of cash flows expected to be collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At September 30, 2013, the decline in market value of the impaired securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities and it is not more likely than not that it will be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2013.

At September 30, 2013 and December 31, 2012, the Company had no securities which have been impaired more than twelve months. At September 30, 2013, the Company had three U.S. Government agency securities and a mutual fund which have been impaired for less than twelve months. The three U.S. Government agency securities had an aggregate fair value of $6,303,000 and unrealized losses of $7,000. The mutual fund had a fair value of $3,787,000 and an unrealized loss of $213,000.

At September 30, 2012, the Company had three private label mortgage-backed securities which had been impaired more than twelve months. The three private label mortgage-backed securities had an aggregate fair value of $8,814,000 and unrealized losses of approximately $394,000 at September 30, 2012. All three private label mortgage-backed securities were rated less than high credit quality at September 30, 2012. The Company evaluated these three private label mortgage-backed securities for OTTI by comparing the present value of expected cash flows to previous estimates to determine whether there had been adverse changes in cash flows during the period. The OTTI evaluation was conducted utilizing the services of a third party specialist and consultant in Mortgage Backed Securities (MBS) and Collateralized Mortgage Obligations (CMO) products. The cash flow assumptions used in the evaluation at September 30, 2012 utilized a discounted cash flow valuation technique using a “Liquidation Scenario” whereby loans are evaluated by delinquency and are assigned probability of default and loss factors deemed appropriate in the current economic environment. The liquidation scenario assumes that all loans 60 or more days past due are liquidated and losses are realized over a period of between six and twenty-four months based upon current 3-month trailing loss severities obtained from reputable financial data sources. In determining fair value under the discounted cash flow analysis, all loans within the mortgage pools, including those less than 60 or more past due, are evaluated for other-than-temporary impairment utilizing the following components:

- Collateral Cash Flows: Loan level cash flows are evaluated based upon estimated prepayment speeds, default rates, and estimated loss severities of liquidated assets.

- Prepayment Assumptions: Prepayment speeds are based upon the borrower’s incentive to pay as well as their ability to pay based upon their credit. In addition, conditional prepayment rates (CPR) and conditional repayment rates (CRR) are evaluated.

- Default Rates: The default assumptions are vectored and are expressed as conditional default rates (CDR), which are based upon the current status of the loan. The model assumes that the 60 day plus population will move to repossession inventory subject to loss migration assumptions and liquidate over the next 24 months. Defaults vector from month 25 to month 36 to the month 37 CDR value. The loans less than 60 days delinquent influence the month 37 CDR value. The default assumptions continue from month 37 but vector down over an extended period of at least 15 years from the valuation date. Default rate assumptions are benchmarked to the recent results experienced by major servicers of of non-Agency MBS for securities with similar attributes and forecasts from the industry experts and industry research.

- Loss Severity: Estimates of loss severity for each loan are based upon initial LTV ratios, the loan's lien position, mortgage insurance coverage, and any change in the property's price since the loan was originated.

- Bond Waterfall: With other components of the individual loans within the collateralized mortgage pools evaluated, the cash flows are allocated to securities based upon contractual waterfall rules provided in the securities prospectus.

- Internal Rate of Return: Future estimated cash flow streams are discounted at pretax yield rates calculated using both credit and non-credit components to determine what the required IRRs would be for similar securities in a market that is generally illiquid.

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As a result of the impairment evaluation, the Company determined that there had been adverse changes in cash flows in all three of the private label mortgage-backed securities, and concluded that these three private label mortgage-backed securities were other-than-temporarily impaired. At September 30, 2012, the three private label mortgage-backed securities had cumulative other-than-temporary-impairment losses of $2,645,000, $394,000 of which was recorded in other comprehensive loss. During the nine months ended September 30, 2012, the company recorded OTTI impairment expense of $284,000 on the three private label mortgage-backed securities. These three private label mortgage-backed securities remained classified as available for sale at September 30, 2012 and were subsequently sold during the fourth quarter of 2012.

The following table details the three private label mortgage-backed securities with other-than-temporary-impairment, their credit rating at September 30, 2012, the related credit losses recognized in earnings during the quarter, and impairment losses in other comprehensive loss:

September 30, 2012	RALI 2006-QS1G A10	RALI 2006 QS8 A1	CWALT 2007-8CB A9	
(in thousands)	Rated D	Rated D	Rated CCC	Total
Amortized cost – before OTTI	$3,611	$1,101	$6,747	$11,459
Credit loss	(771)	(232)	(1,248)	(2,251)
Other impairment (OCI)	(124)	(5)	(265)	(394)
Carrying amount – September 30, 2012	$2,716	$864	$5,234	$8,814
Total impairment - September 30, 2012	$(895)	$(237)	$(1,513)	$(2,645)

The following table summarizes amounts related to credit losses recognized in earnings for the three and nine months ended ended September 30, 2013 and 2012.

(in thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Beginning balance - credit losses	$ —	$ 2,277	$ —	$ 2,257
Additions:				
Initial credit impairments	—	—	—	—
Subsequent credit impairments	—	113	—	284
Reductions:				
For securities sold or credit losses realized on principal payments	—	(139)	—	(290)
Due to change in intent or requirement to sell	—	—	—	—
For increase expected in cash flows	—	—	—	—
Ending balance - credit losses	$ —	$ 2,251	$ —	$ 2,251

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3. Loans and Leases

Loans are comprised of the following:

(In thousands)	September 30, 2013	December 31, 2012
Commercial and business loans	$68,606	$69,780
Government program loans	2,200	2,337
Total commercial and industrial	70,806	72,117
Real estate – mortgage:		
Commercial real estate	142,366	133,599
Residential mortgages	50,502	55,016
Home Improvement and Home Equity loans	1,469	1,319
Total real estate mortgage	194,337	189,934
RE construction and development	83,676	90,941
Agricultural	24,980	36,169
Installment	10,231	10,884
Commercial lease financing	0	12
Total Loans	$384,030	$400,057

The Company's loans are predominantly in the San Joaquin Valley and the greater Oakhurst/East Madera County area, as well as the Campbell area of Santa Clara County. Although the Company does participate in loans with other financial institutions, they are primarily in the state of California.

Commercial and industrial loans represent 18.4% of total loans at September 30, 2013 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans generally comes from the cash flow of the borrower.

Real estate mortgage loans, representing 50.6% of total loans at September 30, 2013, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings and shopping centers; apartments and motels; owner-occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

- Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and are generally of a shorter term than conventional mortgages, with maturities ranging from 3 to 15 years on average.

- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans, and are offered to borrowers for the purpose of home improvements, although the proceeds may be used for other

purposes. Home equity loans are generally secured by junior trust deeds, but may be secured by 1st trust deeds.

Real estate construction and development loans, representing 21.8% of total loans at September 30, 2013, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future

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development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 6.5% of total loans at September 30, 2013 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 2.7% of total loans at September 30, 2013 and generally consist of loans to individuals for household, family and other personal expenditures such as credit cards, automobiles or other consumer items.

Commercial lease financing loans, consist of loans to small businesses, which are secured by commercial equipment. Repayment of the lease obligation is from the cash flow of the borrower. The Company has no commercial lease financing loans at September 30, 2013.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At September 30, 2013 and December 31, 2012, these financial instruments include commitments to extend credit of $71,626,000 and $60,050,000, respectively, and standby letters of credit of $3,001,000 and $2,404,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company’s exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

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Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. The following is a summary of delinquent loans at September 30, 2013 (in thousands):

September 30, 2013	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$352	$—	$—	$352	$68,254	$68,606	$—
Government Program Loans	—	—		—	2,200	2,200	—
Total Commercial and Industrial	352	—	—	352	70,454	70,806	—
Commercial Real Estate Loans		506	7,165	7,671	134,695	142,366	—
Residential Mortgages		858	257	1,115	49,387	50,502	—
Home Improvement and Home Equity Loans	92		—	92	1,377	1,469	—
Total Real Estate Mortgage	92	1,364	7,422	8,878	185,459	194,337	—
RE Construction and Development Loans	—	315	—	315	83,361	83,676	—
Agricultural Loans	—	—	—	—	24,980	24,980	—
Consumer Loans	71	—	—	71	9,846	9,917	—
Overdraft protection Lines	—	—	—	—	97	97	—
Overdrafts	—	—	—	—	217	217	—
Total Installment/other	71	—	—	71	10,160	10,231	—
Commercial Lease Financing	—	—	—	—	—	—	—
Total Loans	$515	$1,679	$7,422	$9,616	$374,414	$384,030	$—

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The following is a summary of delinquent loans at December 31, 2012 (in thousands):

December 31, 2012	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$65	$—	$256	$321	$69,459	$69,780	$—
Government Program Loans	88	—	—	88	2,249	2,337	—
Total Commercial and Industrial	153	—	256	409	71,708	72,117	—
Commercial Real Estate Loans	3,152	2,130	5,328	10,610	122,989	133,599	—
Residential Mortgages	333	322	437	1,092	53,924	55,016	—
Home Improvement and Home Equity Loans	119	140	—	259	1,060	1,319	—
Total Real Estate Mortgage	3,604	2,592	5,765	11,961	177,973	189,934	—
RE Construction and Development Loans	—	—	—	—	90,941	90,941	—
Agricultural Loans	—	136	—	136	36,033	36,169	—
Consumer Loans	305	34	—	339	10,300	10,639	—
Overdraft protection Lines	—	—	—	—	90	90	—
Overdrafts	—	—	—	—	155	155	—
Total Installment	305	34	—	339	10,545	10,884	—
Commercial Lease Financing	—	—	—	—	12	12	—
Total Loans	$4,062	$2,762	$6,021	$12,845	$387,212	$400,057	$—

Nonaccrual Loans

Commercial, construction and commercial real estate loans are placed on non-accrual status under the following circumstances:

- When there is doubt regarding the full repayment of interest and principal.

- When principal and/or interest on the loan has been in default for a period of 90-days or more, unless the asset is both well secured and in the process of collection that will result in repayment in the near future.

- When the loan is identified as having loss elements and/or is risk rated "8" Doubtful.

Other circumstances which jeopardize the ultimate collectability of the loan including certain troubled debt restructurings, identified loan impairment, and certain loans to facilitate the sale of OREO.

Loans meeting any of the preceding criteria are placed on non-accrual status and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

All other loans where principal or interest is due and unpaid for 90 days or more are placed on non-accrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

When a loan is placed on non-accrual status and subsequent payments of interest (and principal) are received, the interest received may be accounted for in two separate ways.

Cost recovery method: If the loan is in doubt as to full collection, the interest received in subsequent payments is diverted from interest income to a valuation reserve and treated as a reduction of principal for financial reporting purposes.

Cash basis: This method is only used if the recorded investment or total contractual amount is expected to be fully collectible, under which circumstances the subsequent payments of interest are credited to interest income as received.

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Loans on non-accrual status are usually not returned to accrual status unless all delinquent principal and/or interest has been brought current, there is no identified element of loss, and current and continued satisfactory performance is expected (loss of the contractual amount not the carrying amount of the loan). Repayment ability is generally demonstrated through the timely receipt of at least six monthly payments on a loan with monthly amortization.

Nonaccrual loans totaled $11,925,000 and $13,425,000 at September 30, 2013 and December 31, 2012, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at September 30, 2013 or December 31, 2012.

The following is a summary of nonaccrual loan balances at September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
Commercial and Business Loans	$—	$1,093
Government Program Loans	—	88
Total Commercial and Industrial	—	1,181
Commercial Real Estate Loans	9,316	8,415
Residential Mortgages	1,729	1,834
Home Improvement and Home Equity Loans	—	10
Total Real Estate Mortgage	11,045	10,259
RE Construction and Development Loans	880	1,730
Agricultural Loans	—	136
Consumer Loans	—	119
Overdraft protection Lines	—	—
Overdrafts	—	—
Total Installment	—	119
Commercial lease Financing	—	—
Total Loans	$11,925	$13,425

Impaired Loans

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, including principal and interest, according to the contractual terms of the loan agreement.

The Company applies its normal loan review procedures in making judgments regarding probable losses and loan impairment. The Company evaluates for impairment those loans on non-accrual status, graded doubtful, graded substandard or those that are troubled debt restructures. The primary basis for inclusion in impaired status under generally accepted accounting pronouncements is that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement.

A loan is not considered impaired if there is merely an insignificant delay or shortfall in the amounts of payments and the Company expects to collect all amounts due, including interest accrued, at the contractual interest rate for the period of the delay.

Review for impairment does not include large groups of smaller balance homogeneous loans that are collectively evaluated to estimate the allowance for loan losses. The Company's present allowance for loan losses methodology, including migration analysis, captures required reserves for these loans in the formula allowance.

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For loans determined to be impaired, the Company evaluates impairment based upon either the fair value of underlying collateral, discounted cash flows of expected payments, or observable market price.

- For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable.

- The discounted cash flow method of measuring the impairment of a loan is used for unsecured loans or for loans secured by collateral where the fair value cannot be easily determined. Under this method, the Company assesses both the amount and timing of cash flows expected from impaired loans. The estimated cash flows are discounted using the loan's effective interest rate. The difference between the amount of the loan on the Bank's books and the discounted cash flow amounts determines the amount of impairment to be provided. This method is used for most of the Company’s troubled debt restructurings or other impaired loans where some payment stream is being collected.

- The observable market price method of measuring the impairment of a loan is only used by the Company when the sale of loans or a loan is in process.

The method for recognizing interest income on impaired loans is dependent on whether the loan is on nonaccrual status or is a troubled debt restructuring. For income recognition, the existing nonaccrual and troubled debt restructuring policies are applied to impaired loans. Generally, except for certain troubled debt restructurings which are performing under the restructure agreement, the Company does not recognize interest income received on impaired loans, but reduces the carrying amount of the loan for financial reporting purposes.

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves or charge-offs when required.

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The following is a summary of impaired loans at, and for the nine months ended September 30, 2013 (in thousands).

September 30, 2013	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	$698	$284	$418	$702	$5	$882	$40
Government Program Loans	—	—	—	—	—	47	—
Total Commercial and Industrial	698	284	418	702	5	929	40
Commercial Real Estate Loans	11,995	5,982	6,022	12,004	739	10,832	275
Residential Mortgages	5,444	1,710	3,744	5,454	109	6,391	162
Home Improvement and Home Equity Loans	—	—		—	—	18	—
Total Real Estate Mortgage	17,439	7,692	9,766	17,458	848	17,241	437
RE Construction and Development Loans	3,420	3,126	316	3,442	88	2,425	66
Agricultural Loans	48	48	—	48	—	96	7
Consumer Loans	48	48	—	48	—	80	3
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	48	48	—	48	—	80	3
Commercial Lease Financing	—	—	—	—	—	—	—
Total Impaired Loans	$21,653	$11,198	$10,500	$21,698	$941	$20,771	$553

(1) The recorded investment in loans includes accrued interest receivable of $45,000.

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The following is a summary of impaired loans at, and for the year ended, December 31, 2012 (in thousands).

December 31, 2012	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	$1,488	$767	$576	$1,343	$37	$5,468	$26
Government Program Loans	109	88	—	88	—	147	—
Total Commercial and Industrial	1,597	855	576	1,431	37	5,615	26
Commercial Real Estate Loans	11,393	6,818	4,237	11,055	436	8,498	135
Residential Mortgages	7,461	3,726	3,666	7,392	185	4,416	251
Home Improvement and Home Equity Loans	10	10	—	10	—	21	—
Total Real Estate Mortgage	18,864	10,554	7,903	18,457	621	12,935	386
RE Construction and Development Loans	1,730	1,730	—	1,730	—	7,298	—
Agricultural Loans	504	192	—	192	—	991	50
Consumer Loans	139	121	—	121	—	200	6
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	139	121	—	121	—	200	6
Lease Financing	—	—	—	—	—	—	—
Total Impaired Loans	$22,834	$13,452	$8,479	$21,931	$658	$27,039	$468

(1) The recorded investment in loans includes accrued interest receivable of 24,000,

In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructurings for which the loan is performing under the current contractual terms for a reasonable period of time, income is recognized under the accrual method.

The average recorded investment in impaired loans for the quarter ended September 30, 2013 and 2012 was $21,698,000 and $21,143,000, respectively. The average recorded investment in impaired loans for the nine months ended September 30, 2013 and 2012 was $20,771,000 and $28,317,000, respectively.

Interest income recognized on impaired loans for the quarters ended September 30, 2013 and 2012 was approximately $336,000 and $113,000, respectively. Interest income recognized on impaired loans for the nine months ended September 30, 2013 and 2012 was approximately $553,000 and $366,000, respectively.

Troubled Debt Restructurings

Under the circumstances, when the Company grants a concession to a borrower as part of a loan restructuring, the restructuring is accounted for as a troubled debt restructuring (TDR). TDRs are reported as a component of impaired loans.

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A TDR is a type of restructuring in which the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession (either imposed by court order, law, or agreement between the borrower and the Bank) to the borrower that it would not otherwise consider. Although the restructuring may take different forms, the Company's objective is to maximize recovery of its investment by granting relief to the borrower.
A TDR may include, but is not limited to, one or more of the following:

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.

- A modification of terms of a debt such as one or a combination of:

The reduction (absolute or contingent) of the stated interest rate.
The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.
The reduction (absolute or contingent) of accrued interest.
For a restructured loan to return to accrual status there needs to be, among other factors, at least 6 months successful payment history. In addition, the Company performs a financial analysis of the credit to determine whether the borrower has the ability to continue to meet payments over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and cash flow analysis of the borrower. Only after determination that the borrower has the ability to perform under the terms of the loans, will the restructured credit be considered for accrual status. Although the Company does not have a policy which specifically addresses when a loan may be removed from TDR classification, as a matter of practice, loans classified as TDRs generally remain classified as such until the loan either reaches maturity or its outstanding balance is paid off.

The following tables illustrates TDR activity for the periods indicated:

	Nine Months Ended September 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	$—	$—	—	$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	1	106
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	40	2,561	2,540	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	40	$2,561	$2,540	1	$106

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	Three Months Ended September 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	$—	$—	—	$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	22	2,103	2,103	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	22	$2,103	$2,103	—	$—

	Nine Months Ended September 30, 2012				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	2	$156	$151	—	$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	5	992	914	—	—
Single Family Residential Loans	1	329	324	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	56	—	—
Consumer Loans	—	—	20	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	8	$1,477	$1,465	—	$—

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	Three Months Ended September 30, 2012				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	2	$ 156	$ 151	—	$ —
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	2	$ 156	$ 151	—	$ —

The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At September 30, 2013, the Company had 56 restructured loans totaling $13,340,000 as compared to 58 restructured loans totaling $16,773,000 at December 31, 2012.

The following tables summarize TDR activity by loan category for the nine months ended September 30, 2013 and September 30, 2012.

Nine Months Ended September 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	$ 990	$ 5,395	$ 7,289	$ 10	$ 2,860	$ 191	$ 38	$ —	$ 16,773
Defaults	—	(106)	—	—	—	—	—	—	(106)
Additions	—	—	—	44	3,901	—	—	—	3,945
Principal reductions	(292)	(1,113)	(1,976)	(54)	(3,656)	(143)	(38)	—	(7,272)
Ending balance	$ 698	$ 4,176	$ 5,313	$ —	$ 3,105	$ 48	$ —	$ —	$ 13,340
Allowance for loan loss	$ 5	$ 739	$ 109	$ —	$ 88	$ —	$ —	$ —	$ 941

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Nine Months Ended September 30, 2012	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	$2,619	$6,850	$3,457	$36	$ 6,034	$—	$54	$—	$19,050
Defaults	—	—	—	—	—	—	—	—	—
Additions	151	914	324	—	—	56	20	—	1,465
Principal reductions	(308)	(1,456)	(135)	(25)	(2,375)	—	(34)	—	(4,333)
Ending balance	$2,462	$6,308	$3,646	$11	$ 3,659	$56	$40	$—	$16,182
Allowance for loan loss	$152	$325	$128	$—	$ 6	$—	$—	$—	$611

The following tables summarize TDR activity by loan category for the quarters ended September 30, 2013 and September 30, 2012.

Three months ended September 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	$812	$4,215	$6,783	$44	$ 2,411	$51	$—	$—	$14,316
Defaults	—	—	—	—	—	—	—	—	—
Additions	—	—	—	—	2,103	—	—	—	2,103
Principal reductions	(114)	(39)	(1,470)	(44)	(1,409)	(3)	—	—	(3,079)
Ending balance	$698	$4,176	$5,313	$—	$ 3,105	$48	$—	$—	$13,340
Allowance for loan loss	$5	$739	$109	$0	$ 88	$—	$—	$—	$941

Three months ended September 30, 2012	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
	$2,359	$6,355	$3,774	$12	$ 4,147	$57	$58	$—	$16,762

Beginning balance									
Defaults	—	—	—	—	—	—	—	—	—
Additions	151	—	—	—	—	—	—	—	151
Principal reductions	(48)	(47)	(128)	(1)	(488)	(1)	(18)	—	(731)
Ending balance	$2,462	$6,308	$3,646	$11	$ 3,659	$56	$40	$—	$16,182
Allowance for loan loss	$152	$325	$128	$—	$ 6	$—	$—	$—	$611

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Credit Quality Indicators

As part of its credit monitoring program, the Company utilizes a risk rating system which quantifies the risk the Company estimates it has assumed during the life of a loan. The system rates the strength of the borrower and the facility or transaction, and is designed to provide a program for risk management and early detection of problems.

For each new credit approval, credit extension, renewal, or modification of existing credit facilities, the Company assigns risk ratings utilizing the rating scale identified in this policy. In addition, on an on-going basis, loans and credit facilities are reviewed for internal and external influences impacting the credit facility that would warrant a change in the risk rating. Each loan credit facility is to be given a risk rating that takes into account factors that materially affect credit quality.

When assigning risk ratings, the Company evaluates two risk rating approaches, a facility rating and a borrower rating as follows:

Facility Rating:

The facility rating is determined by the analysis of positive and negative factors that may indicate that the quality of a particular loan or credit arrangement requires that it be rated differently from the risk rating assigned to the borrower. The Company assesses the risk impact of these factors:

Collateral - The rating may be affected by the type and quality of the collateral, the degree of coverage, the economic life of the collateral, liquidation value and the Company's ability to dispose of the collateral.

Guarantees - The value of third party support arrangements varies widely. Unconditional guaranties from persons with demonstrable ability to perform are more substantial than that of closely related persons to the borrower who offer only modest support.

Unusual Terms - Credit may be extended on terms that subject the Company to a higher level of risk than indicated in the rating of the borrower.

Borrower Rating:

The borrower rating is a measure of loss possibility based on the historical, current and anticipated financial characteristics of the borrower in the current risk environment. To determine the rating, the Company considers at least the following factors:

- Quality of management
- Liquidity
- Leverage/capitalization
- Profit margins/earnings trend
- Adequacy of financial records
- Alternative funding sources

- Geographic risk
- Industry risk
- Cash flow risk
- Accounting practices
- Asset protect ion
- Extraordinary risks

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The Company assigns risk ratings to loans other than consumer loans and other homogeneous loan pools based on the following scale. The risk ratings are used when determining borrower ratings as well as facility ratings. When the borrower rating and the facility ratings differ, the lowest rating applied is:

- Grades 1 and 2 – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the borrower's strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.

- Grade 3 – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower's balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.

- Grades 4 and 5 – These include "pass" grade loans to borrowers of acceptable credit quality and risk. The borrower's balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years, however recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully comply with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are "leveraged" or on management's "watch list." While still considered pass loans (loans given a grade 5), the borrower's financial condition, cash flow or operations evidence more than average risk and short term weaknesses, these loans warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect credit weakness trends that weaken or inadequately protect the Company's credit position. Loans with a grade rating of 5 are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.

- Grade 6 – This grade includes "special mention" loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company's credit position at some future date. Special mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in special mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.

- Grade 7 – This grade includes "substandard" loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt. Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.

- Grade 8 - This grade includes "doubtful" loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of

certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

- Grade 9 - This grade includes loans classified "loss" which are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off the asset even though partial recovery may be achieved in the future.

The Company did not carry any loans graded as loss at September 30, 2013 or December 31, 2012.

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The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for September 30, 2013 and December 31, 2012:

September 30, 2013 (000's)	Commercial and Industrial	Commercial RE	RE Construction and Development	Agricultural	Total
Grades 1 and 2	$790	$—	$—	$70	$860
Grade 3	2,018	5,354	826	—	8,198
Grades 4 and 5 – pass	67,153	127,235	65,430	24,910	284,728
Grade 6 – special mention	698	—	—	—	698
Grade 7 – substandard	147	9,777	17,420	—	27,344
Grade 8 – doubtful	—	—	—	—	—
Total	$70,806	$142,366	$83,676	$24,980	$321,828

December 31, 2012 (000's)	Commercial and Industrial	Commercial RE	RE Construction and Development	Agricultural	Total
Grades 1 and 2	$825	$—	$—	$60	$885
Grade 3	2,071	5,947	856	—	8,874
Grades 4 and 5 – pass	66,098	116,606	75,191	35,973	293,868
Grade 6 – special mention	1,867	—	141	—	2,008
Grade 7 – substandard	1,256	11,046	14,753	136	27,191
Grade 8 – doubtful	—	—	—	—	—
Total	$72,117	$133,599	$90,941	$36,169	$332,826

The Company follows consistent underwriting standards outlined in its loan policy for consumer and other homogeneous loans but, does not specifically assign a risk rating when these loans are originated. Consumer loans are monitored for credit risk and are considered "pass" loans until some issue or event requires that the credit be downgraded to special mention or worse.

The following tables summarize the credit risk ratings for consumer related loans and other homogeneous loans for September 30, 2013 and December 31, 2012:

	September 30, 2013				December 31, 2012			
(000's)	Residential Mortgages	Home Improvement and Home Equity	Installment	Total	Residential Mortgages	Home Improvement and Home Equity	Installment	Total
Not graded	$28,985	$1,437	$8,721	$39,143	$30,727	$1,309	$9,221	$41,257
Pass	19,145	0	1,510	20,655	20,572	0	1,422	21,994
Special Mention	—	32	—	32	909	0	49	958
Substandard	2,372	—	—	2,372	2,808	10	192	3,010
Total	$50,502	$1,469	$10,231	$62,202	$55,016	$1,319	$10,884	$67,219

Allowance for Loan Losses

The Company analyzes risk characteristics inherent in each loan portfolio segment as part of the quarterly review of the adequacy of the allowance for loan losses. The following summarizes some of the key risk characteristics for the eleven segments of the loan portfolio (Consumer loans include three segments):

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Commercial and business loans – Commercial loans are subject to the effects of economic cycles and tend to exhibit increased risk as economic conditions deteriorate, or if the economic downturn is prolonged. The Company considers this segment to be one of higher risk given the size of individual loans and the balances in the overall portfolio.

Government program loans – This is a relatively a small part of the Company’s loan portfolio, but has historically had a high percentage of loans that have migrated from pass to substandard given there vulnerability to economic cycles.

Commercial real estate loans – This segment is considered to have more risk in part because of the vulnerability of commercial businesses to economic cycles as well as the exposure to fluctuations in real estate prices because most of these loans are secured by real estate. Losses in this segment have however been historically low because most of the loans are real estate secured.

Residential mortgages – This segment is considered to have low risk factors both from the Company and peer statistics. These loans are secured by first deeds of trust. The losses experienced over the past twelve quarters are isolated to approximately seven loans and are generally the result of short sales.

Home improvement and home equity loans – Because of their junior lien position, these loans have an inherently higher risk level. Because residential real estate has been severely distressed in the recent past, the anticipated risk for this loan segment has increased.

Real estate construction and development loans –In a normal economy, this segment of loans is considered to have a higher risk profile due to construction and market value issues in conjunction with normal credit risks. In the current distressed residential real estate markets the risk has increased.

Agricultural loans – This segment is considered to have risks associated with weather, insects, and marketing issues. In addition, concentrations in certain crops or certain agricultural areas can increase risk.

Installment loans (Includes consumer loans, overdrafts, and overdraft protection lines) – This segment is higher risk because many of the loans are unsecured.

Commercial lease financing – This segment of the portfolio is small, but is considered to be vulnerable to economic cycles given the nature of the leasing relationship where businesses are relatively small or have minimal cash flow. This lending program was terminated in 2005.

The following summarizes the activity in the allowance for credit losses by loan category for the nine months ended September 30, 2013 and 2012.

Nine Months Ended September 30, 2013 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$ 1,614	$ 1,292	$ 2,814	$ 352	$ 288	$ 1	$ 5,423	$ 11,784
Provision for credit losses	972	983	1,854	208	259	(1)	(5,395)	(1,120)
Charge-offs	(542)	(265)	—	(136)	(258)	—	—	(1,201)
Recoveries	163	6	738	129	53	—	—	1,089
Net charge-offs	(379)	(259)	738	(7)	(205)	—	—	(112)

Ending balance	$2,207	$2,016	$ 5,406	$ 553	$342	$—	$ 28	$10,552
Period-end amount allocated to:								
Loans individually evaluated for impairment	739	109	—	88	—	—	5	941
Loans collectively evaluated for impairment	1,468	1,907	5,406	465	342	—	23	9,611
Ending balance	$2,207	$2,016	$ 5,406	$ 553	$342	$—	$ 28	$10,552

Nine Months Ended September 30, 2012 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$6,787	$1,416	$ 4,579	$508	$116	$1	$ 241	$13,648
Provision for credit losses	(3,443)	(286)	(965)	2,081	520	1	3,102	1,010
Charge-offs	(887)	(165)	(10)	(2,317)	(296)	—	—	(3,675)
Recoveries	125	8	—	—	44	—	—	177
Net charge-offs	(762)	(157)	(10)	(2,317)	(252)	—	—	(3,498)
Ending balance	$2,582	$973	$ 3,604	$272	$384	$2	$ 3,343	$11,160
Period-end amount allocated to:								
Loans individually evaluated for impairment	152	709	6	—	46	—	—	913
Loans collectively evaluated for impairment	2,430	264	3,598	272	338	2	3,343	10,247
Ending balance	$2,582	$973	$ 3,604	$272	$384	$2	$ 3,343	$11,160

The following summarizes the activity in the allowance for credit losses by loan category for the quarters ended September 30, 2013 and 2012.

Three Months Ended September 30, 2013 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$2,665	$1,679	$ 2,972	$ 243	$315	$—	$ 3,283	$11,157
Provision for credit losses	(390)	383	1,696	181	235	—	(3,255)	(1,150)
Charge-offs	(193)	(49)	—		(232)	—	—	(474)
Recoveries	125	3	738	129	24	—	—	1,019
Net charge-offs	(68)	(46)	738	129	(208)	—	—	545
Ending balance	$2,207	$2,016	$ 5,406	$ 553	$342	$—	$ 28	$10,552
Period-end amount allocated to:								
	739	109	—	88	—	—	5	941

Loans individually evaluated for impairment								
Loans collectively evaluated for impairment	1,468	1,907	5,406	465	342	—	23	9,611
Ending balance	$2,207	$2,016	$ 5,406	$ 553	$342	$—	$ 28	$10,552

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Three Months Ended September 30, 2012 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$3,564	$1,054	$ 5,800	$277	$346	$3	$ 565	$11,609
Provision for credit losses	(922)	27	(2,196)	143	175	(1)	2,778	4
Charge-offs	(124)	(112)	—	(148)	(159)	—	—	(543)
Recoveries	64	4	—	—	22	—	—	90
Net charge-offs	(60)	(108)	0	(148)	(137)	—	—	(453)
Ending balance	$2,582	$973	$ 3,604	$272	$384	$2	$ 3,343	$11,160
Period-end amount allocated to:								
Loans individually evaluated for impairment	152	709	6	—	46	—	—	913
Loans collectively evaluated for impairment	2,430	264	3,598	272	338	2	3,343	10,247
Ending balance	$2,582	$973	$ 3,604	$272	$384	$2	$ 3,343	$11,160

The following summarizes information with respect to the loan balances at September 30, 2013 and December 31, 2012.

(000's)	September 30, 2013			December 31, 2012		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and Business Loans	$702	$67,904	$68,606	$1,343	$68,437	$69,780
Government Program Loans	—	2,200	2,200	88	2,249	2,337
Total Commercial and Industrial	702	70,104	70,806	1,431	70,686	72,117
Commercial Real Estate Loans	12,004	130,362	142,366	11,055	122,544	133,599
Residential Mortgage Loans	5,454	45,048	50,502	7,392	47,624	55,016
Home Improvement and Home Equity Loans	—	1,469	1,469	10	1,309	1,319
Total Real Estate Mortgage	17,458	176,879	194,337	18,457	171,477	189,934
Total RE Construction and Development Loans	3,442	80,234	83,676	1,730	89,211	90,941

Total Agricultural Loans	48	24,932	24,980	192	35,977	36,169
Total Installment Loans	48	10,183	10,231	121	10,763	10,884
Commercial Lease Financing	—	—	—	—	12	12
Total Loans	$21,698	$362,332	$384,030	$21,931	$378,126	$400,057

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4. Deposits

Deposits include the following:

(In thousands)	September 30, 2013	December 31, 2012
Noninterest-bearing deposits	$236,112	$217,014
Interest-bearing deposits:		
NOW and money market accounts	201,860	203,771
Savings accounts	42,302	43,117
Time deposits:		
Under $100,000	30,144	32,532
$100,000 and over	61,058	66,853
Total interest-bearing deposits	335,364	346,273
Total deposits	$571,476	$563,287
Total brokered deposits included in time deposits above	$14,940	$17,984

5. Short-term Borrowings/Other Borrowings

At September 30, 2013, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling $265,792,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling $7,498,000. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time. There are currently no restrictions on these lines of credit, although under the current Written Agreement with the Federal Reserve, the Bank’s liquidity position as well as its use of borrowing lines is monitored closely. These lines of credit have interest rates that are generally tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB lines of credit are collateralized by investment securities, while lines of credit with the Federal Reserve Bank are collateralized by certain qualifying loans. As of September 30, 2013, $7,898,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, $344,261,000 in qualifying loans were pledged at September 30, 2013 as collateral for borrowing lines with the Federal Reserve Bank totaling $265,792,000. At September 30, 2013, the Company had no outstanding borrowings.

At December 31, 2012, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco totaling $217,841,000, as well as Federal Home Loan Bank (“FHLB”) lines of credit totaling $10,493,000. At December 31, 2012, the Company had no outstanding borrowing balances. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company’s stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2012, $11,054,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, $324,462,000 in real estate-secured loans were pledged at December 31, 2012, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling $217,841,000. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time. At December 31, 2012, the Company had no outstanding borrowings.

6. Supplemental Cash Flow Disclosures

	Nine Months Ended September 30,	
(In thousands)	2013	2012
Cash paid during the period for:		
Interest	$1,056	$1,580

Income Taxes	$—	$—
Noncash investing activities:		
Loans transferred to foreclosed assets	$437	$—
OREO financed	$2,328	$—

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7. Common Stock Dividend

On September 24, 2013, the Company’s Board of Directors declared a one-percent (1%) stock dividend on the Company’s outstanding common stock. Based upon the number of outstanding common shares on the record date of October 11, 2013, 145,061 additional shares were issued to shareholders on October 23, 2013. Because the stock dividend was considered a “small stock dividend,” approximately $618,000 was transferred from retained earnings to common stock based upon the $4.26 closing price of the Company’s common stock on the declaration date of September 24, 2013. There were no fractional shares paid. Except for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company’s weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

During the first quarter of 2013, the Company's Board of Director's issued a one-percent (1%) stock dividend on the Company's outstanding common stock. Approximately $619,000 was transferred from retained earnings to common stock and 142,157 additional shares were issued to shareholders. During the second quarter of 2013, the Company's Board of Director's issued a one-percent (1%) stock dividend on the Company's outstanding common stock. Approximately $603,000 was transferred from retained earnings to common stock and 143,613 additional shares were issued to shareholders.

8. Net Income per Common Share

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income available to common shareholders (in thousands)	$1,852	$1,366	$4,323	$4,591
Weighted average shares issued	14,653,336	14,507,796	14,650,992	14,507,796
Add: dilutive effect of stock options	234	—	923	—
Weighted average shares outstanding adjusted for potential dilution	14,653,570	14,507,796	14,651,915	14,507,796
Basic earnings per share	$0.13	$0.09	$0.30	$0.32
Diluted earnings per share	$0.13	$0.09	$0.30	$0.32
Anti-dilutive stock options excluded from earnings per share calculation	187,000	159,000	191,000	159,000

9. Taxes on Income

The Company periodically reviews its tax positions under the accounting standards related to uncertainty in income taxes, which defines the criteria that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity’s financial statements. Under the guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term “more likely than not” means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by

the applicable taxing authority and all available information is known to the taxing authority.

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At September 30, 2013 and December 31, 2012, the Company had a recorded valuation allowance of $2,686,000. The Company performs an analysis of the valuation allowance considering both tax planning strategies and future earnings as a basis for utilizing the deferred tax assets. The tax planning strategies include the sale of certain bank premise and the surrender of Bank Owned Life Insurance. In its review of a requirement for a valuation allowance, the Company identifies both positive and negative evidence to determine whether a valuation allowance is required. Negative evidence would include pretax losses recorded during each of the last three calendar years. These losses were the result of the severe economic downturn that began in 2008 resulting in substantial increases in the

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provision for loan losses as well as impairment losses related to other real estate owned through foreclosure, goodwill, and private label residential mortgage obligations. At December 31, 2012 and September 30, 2013, the Company performed an analysis of future projected earnings to provide positive evidence that sufficient earnings would be generated to utilize the deferred tax assets. Underlying assumptions included continued reductions in nonperforming assets and general improvements in the economy, resulting in reduced provisions for loans losses and impairment charges, as well as reductions in expenses related to other real estate owned. Based upon this analysis, the Company has concluded that the valuation allowance of $2,686,000 at September 30, 2013 and December 31, 2012 is reasonable.

The Company and its subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. During 2010, the Company amended its federal tax returns for the year 2004 through 2009 to utilize the five-year NOL carry-back provisions allowed by the IRS for 2009. These amended tax returns were audited by the IRS and the examination was finalized during the first quarter of 2013 and the settlement did not have a material impact on the Company’s financial statements. The Company is not currently aware of any other tax jurisdictions where the Company or any subsidiary is subject to examination by federal, state, or local taxing authorities.

10. Junior Subordinated Debt/Trust Preferred Securities

Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Company elected to defer interest payments on the Company's $15.0 million of junior subordinated debentures relating to its trust preferred securities. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals are elected, the Company will continue to record interest expense associated with the debentures. Upon the expiration of the deferral period, all accrued and unpaid interest will be due and payable. During the deferral period, the Company is precluded from paying cash dividends to shareholders or repurchasing its stock.

The fair value guidance generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. Effective January 1, 2008, the Company elected the fair value option for its junior subordinated debt issued under USB Capital Trust II. The rate paid on the junior subordinated debt issued under USB Capital Trust II is 3-month LIBOR plus 129 basis points, and is adjusted quarterly.

At September 30, 2013 the Company performed a fair value measurement analysis on its junior subordinated debt using a cash flow model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month LIBOR curve to estimate future quarterly interest payments due over the thirty-year life of the debt instrument, adjusted for deferrals of interest payments per the Company’s election at September 30, 2009. These cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. Although there is little market data in the current relatively illiquid credit markets, we believe the 8.08% discount rate used represents what a market participant would consider under the circumstances based on current market assumptions.

The fair value calculation performed at September 30, 2013 resulted in a pretax gain adjustment of $141,000 ($83,000, net of tax) for the quarter ended September 30, 2013 and a pretax loss adjustment of $519,000 ($305,000, net of tax) for the nine months ended September 30, 2013. The previous year’s fair value calculation performed at September 30, 2012 resulted in pretax loss adjustment of $171,000 ($101,000, net of tax) for the quarter ended September 30, 2012, and a pretax loss adjustment of $284,000 ($133,000, net of tax) for the nine months ended September 30, 2012.

11. Fair Value Measurements and Disclosure

The following summary disclosures are made in accordance with the guidance provided by ASC Topic 825, Fair Value Measurements and Disclosures (formerly Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments), which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate that value.

Generally accepted accounting guidance clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This guidance applies whenever other accounting pronouncements require or permit fair value measurements.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3). Level 1 inputs are unadjusted quoted prices in active markets (as defined) for identical assets or

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liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The table below is a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized at the periods indicated:

September 30, 2013

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	$181,842	$181,842	$181,842	$—	$—
Interest-bearing deposits	1,513	1,513	—	1,513	—
Investment securities	32,577	32,577	10,803	21,774	—
Loans	373,440	369,388	—	—	369,388
Accrued interest receivable	1,397	1,397	—	1,397	—
Financial Liabilities:					
Deposits:					
Noninterest-bearing	236,112	236,112	236,112	—	—
NOW and money market	201,860	201,860	201,860	—	—
Savings	42,302	42,302	42,302	—	—
Time Deposits	91,202	91,357	—	—	91,357
Total Deposits	571,476	571,631	480,274		91,357
Junior Subordinated Debt	10,804	10,804	—	—	10,804
Accrued interest payable	57	57	—	57	—

December 31, 2012

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	$141,627	$141,627	$141,627	$—	$—
Interest-bearing deposits	1,507	1,507	—	1,507	—
Investment securities	31,844	31,844	13,593	18,251	—
Loans	388,249	386,836	—	—	386,836
Accrued interest receivable	1,694	1,694	—	1,694	—
Financial Liabilities:					
Deposits:					
Noninterest-bearing	217,014	217,014	217,014	—	—
NOW and money market	203,771	203,771	203,771	—	—
Savings	43,117	43,117	43,117	—	—
Time Deposits	99,385	99,529	—	—	99,529
Total Deposits	563,287	563,431	463,902	—	99,529

Junior Subordinated Debt	10,068	10,068	—	—	10,068
Accrued interest payable	71	71	—	71	—

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The Company performs fair value measurements on certain assets and liabilities as the result of the application of current accounting guidelines. Some fair value measurements, such as available-for-sale securities (AFS) and junior subordinated debt are performed on a recurring basis, while others, such as impairment of loans, other real estate owned, goodwill and other intangibles, are performed on a nonrecurring basis.

The Company's Level 1 financial assets consist of money market funds and highly liquid mutual funds for which fair values are based on quoted market prices. The Company's Level 2 financial assets include highly liquid debt instruments of U.S. government agencies, collateralized mortgage obligations, and debt obligations of states and political subdivisions, whose fair values are obtained from readily-available pricing sources for the identical or similar underlying security that may, or may not, be actively traded. The Company's Level 3 financial assets include certain investments securities, certain impaired loans, other real estate owned, goodwill, and intangible assets where the assumptions may be made by us or third parties about assumptions that market participants would use in pricing the asset or liability. From time to time, the Company recognizes transfers between Level 1, 2, and 3 when a change in circumstances warrants a transfer. There were no significant transfers in or out of Level 1 and Level 2 fair value measurements during the three months ended September 30, 2013.

The following methods and assumptions were used in estimating the fair values of financial instruments:

Cash and Cash Equivalents - The carrying amounts reported in the balance sheets for cash and cash equivalents approximate their estimated fair values.

Interest-bearing Deposits – Interest bearing deposits in other banks consist of fixed-rate certificates of deposits. Accordingly, fair value has been estimated based upon interest rates currently being offered on deposits with similar characteristics and maturities.

Investments – Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a Level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a forward spread from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded through other comprehensive loss as the securities are available for sale.

Loans - Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values adjusted for credit risk. Fair values for all other loans, except impaired loans, are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities.

Impaired Loans - Fair value measurements for impaired loans are performed pursuant to authoritative accounting guidance and are based upon either collateral values supported by appraisals, observed market prices, or discounted cash flows. Changes are not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve. Such adjustments to the estimated fair value of impaired loans may result in increases or decreases to the provision for credit losses recorded in current earnings.

Other Real Estate Owned - Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In

cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Goodwill and Core Deposit Intangibles - Goodwill is not amortized but is evaluated periodically for impairment. Fair value of goodwill is determined by comparing the fair value of the operating unit with its carrying value. Fair value is determined on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the related operating unit. In addition to projected cash flows, other market metrics are utilized including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes in discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If it is determined that goodwill impairment exists, impairment amounts are recorded as an impairment loss in other non-interest expense, and the carrying value of goodwill is reduced by the amount of the impairment. Core deposit intangibles are amortized over the estimated useful lives of the related deposits and are evaluated for impairment periodically. Core deposit intangibles are reviewed for impairment utilizing a discounted cash flow methodology based upon the anticipated deposit

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runoff over the estimated lives of the deposits, generally six to eight years. If it is determined that impairment exists on the core deposit intangible, impairment amounts are recorded as an impairment loss in other non-interest expense, and the carrying value of the core deposit intangible is reduced by the amount of the impairment.

Deposits – In accordance with authoritative accounting guidance, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at September 30, 2013 and December 31, 2012 (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed under authoritative accounting guidance. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Junior Subordinated Debt – The fair value of the junior subordinated debt was determined based upon a discounted cash flows model utilizing observable market rates and credit characteristics for similar debt instruments. In its analysis, the Company used characteristics that market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. For the nine months ended September 30, 2013, cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for credit and liquidity risks associated with similar junior subordinated debt and circumstances unique to the Company. The Company believes that the subjective nature of theses inputs, due primarily to the current economic environment, require the junior subordinated debt to be classified as a Level 3 fair value.

Accrued Interest Receivable and Payable - The carrying value of these instruments is a reasonable estimate of fair value.

Off-balance sheet instruments - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at September 30, 2013 and December 31, 2012.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are not material to the Company's consolidated balance sheet and results of operations.

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at September 30, 2013 and 2012:

September 30, 2013				September 30, 2012			
Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average	Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average
Subordinated Debt	Discounted cash flow	Discount Rate	8.08%	Subordinated Debt	Discounted cash flow	Discount Rate	7.23%

Management believes that the credit risk adjusted spread utilized in the fair value measurement of the junior subordinated debentures carried at fair value is indicative of the nonperformance risk premium a willing market participant would require under current market conditions, that is, the inactive market. Management attributes the change in fair value of the junior subordinated debentures during the period to market changes in the nonperformance expectations and pricing of this type of debt, and not as a result of changes to our entity-specific credit risk. The narrowing of the credit risk adjusted spread above the Company's contractual spreads has primarily contributed to the

negative fair value adjustments. Generally, an increase in the credit risk adjusted spread and/or a decrease in the three month LIBOR swap curve will result in positive fair value adjustments (and decrease the fair value measurement). Conversely, a decrease in the credit risk adjusted spread and/or an increase in the three month LIBOR swap curve will result in negative fair value adjustments (and increase the fair value measurement).

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The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of September 30, 2013 (in 000's):

Description of Assets	September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. government agencies	$26,471	$7,016	$19,455	$—
U.S. government agency CMO's	2,319	—	2,319	—
Mutual Funds	3,787	3,787	—	—
Total AFS securities	$32,577	$10,803	$21,774	$—
Impaired loans (1):				
Commercial and industrial	418	—	—	418
Real estate mortgage	9,766	—	—	9,766
RE construction & development	316	—	—	316
Agricultural	—	—	—	—
Installment/Other	—	—	—	—
Total impaired loans	$10,500	$—	$—	$10,500
Other real estate owned (1)	7,293	—	—	7,293
Total	$50,370	$10,803	$21,774	$17,793

Description of Liabilities	September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	$10,804	—	—	$10,804
Total	$10,804	—	—	$10,804

(1)Nonrecurring
(2)Recurring

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2012 (in 000's):

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Description of Assets	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities:				
U.S Govt agencies	$24,366	$9,632	$14,734	$—
U.S Govt collateralized mortgage obligations	3,517	—	3,517	—
Mutual Funds	3,961	3,961	—	—
Total AFS securities	31,844	13,593	18,251	$—
Impaired Loans (1):				
Commercial and industrial	576	—	—	576
Real estate mortgage	7,903	—	—	7,903
RE construction & development	—	—	—	—
Agricultural	—	—	—	—
Installment/Other	—	—	—	—
Total impaired loans	$8,479	$—	$—	$8,479
Other real estate owned (1)	12,010	—	—	12,010
Total	$52,333	$13,593	$18,251	$20,489

Description of Liabilities	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	$10,068	$—	$—	$10,068
Total	$10,068	$—	$—	$10,068

(1)Nonrecurring
(2)Recurring

The Company recorded an impairment loss of $214,000 on other real estate owned during the nine months ended September 30, 2013. There were no fair value impairment adjustments for the nonrecurring fair value measurements performed during the nine months ended September 30, 2012.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on a recurring basis during the nine months ended September 30, 2013 and 2012 (in 000's):

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Reconciliation of Assets:	Three Months Ended September 30, 2013 Private label mortgage-backed securities	Nine Months Ended September 30, 2013 Private label mortgage-backed securities	Three Months Ended September 30, 2012 Private label mortgage-backed securities	Nine Months Ended September 30, 2012 Private label mortgage-backed securities
Beginning balance	$ —	$ —	$ 8,312	$ 7,973
Total gains or (losses) included in earnings	—	—	(623)	(284)
Total gains or (losses) included in other comprehensive income	—	—	1,125	1,125
Transfers in and/or out of Level 3	—	—	—	—
Ending balance	$ —	$ —	$ 8,814	$ 8,814
The amount of total gains or (losses) for the period included in earnings (or other comprehensive loss) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	$ —	$ —	$ (623)	$ (284)

Reconciliation of Liabilities:	Three Months Ended September 30, 2013 Junior Subordinated Debt	Nine Months Ended September 30, 2013 Junior Subordinated Debt	Three Months Ended September 30, 2012 Junior Subordinated Debt	Nine Months Ended September 30, 2012 Junior Subordinated Debt
Beginning balance	$10,882	$10,068	$9,276	$9,027
Total losses (gains) included in earnings (or changes in net assets)	(141)	519	171	284
Transfers in and/or (out) of Level 3	63	217	68	204
Ending balance	$10,804	$10,804	$9,515	$9,515
The amount of total losses (gains) for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date	$(141)	$519	$171	$284

12. Goodwill and Intangible Assets

At September 30, 2013 and December 31, 2012 the Company had goodwill, core deposit intangibles, and other identified intangible assets which were recorded in connection with various business combinations and purchases. The following table summarizes the carrying value of those assets at September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
Goodwill	$4,488	$4,488
Core deposit intangible assets	109	249
Total goodwill and intangible assets	$4,597	$4,737

Core deposit intangibles are amortized over their useful lives, while goodwill is not amortized. The Company conducts periodic impairment analysis on goodwill and intangible assets at least annually or more often as conditions require.

Goodwill: The largest component of goodwill is related to the Legacy merger (Campbell reporting unit) completed during February 2007 and totaled approximately $2.9 million at September 30, 2013. Annually, the Company conducts its impairment testing of the goodwill related to the Campbell reporting unit. Impairment testing for goodwill is a two-step process.

The first step in impairment testing is to identify potential impairment, which involves determining and comparing the fair value of the operating unit with its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired. If the carrying value exceeds fair value, there is an indication of possible impairment and the second step is performed to determine the amount of the impairment, if any. The fair value determined in the step one testing is determined

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based on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the Campbell reporting unit. In addition to projected cash flows, the Company also utilizes other market metrics including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes is discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If, at the conclusion of the step 1 analysis, the Company concludes that the potential for goodwill impairment exists, step-two testing will be required to determine goodwill impairment and the amount of goodwill that might be impaired, if any. The second step in impairment analysis compares the fair value of the Campbell reporting unit to the aggregate fair values of its individual assets, liabilities and identified intangibles. Based on the results of the first step of the impairment analysis at March 31, 2013, the Company concluded that that the fair value of the reporting unit exceeds it carrying value. Therefore, goodwill was not impaired.

Core Deposit Intangibles: The core deposit intangible asset related to the Legacy Bank Merger, which totaled $3.0 million at the time of merger, was amortized over an estimated life of approximately seven years. At September 30, 2013, there was no remaining carrying value of the core deposit intangible related to the Legacy Bank merger. The Company recognized no amortization expense related to the Legacy operating unit during the nine months ended September 30, 2013. The Company recognized $12,000 in amortization expense related to the Legacy operating unit during the nine months ended September 30, 2012. At September 30, 2013, there was $109,000 in remaining carrying value of core deposit intangible related to the Taft branch acquisitions completed in April 2004.

The Company did not record an impairment loss for the three or nine months ended September 30, 2013 or September 30, 2012.

13. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Unrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued.

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

Overview

Certain matters discussed or incorporated by reference in this Quarterly Report of Form 10-Q are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, but are not limited to, those described in Management’s Discussion and Analysis of Financial Condition and Results of Operations. Such risks and uncertainties include, but are not limited to, the following factors: i) competitive pressures in the banking industry and changes in the regulatory environment; ii) exposure to changes in the interest rate environment and the resulting impact on the Company’s interest rate sensitive assets and liabilities; iii) decline in the health of the economy nationally or regionally which could reduce the demand for loans or reduce the value of real estate collateral securing most of the Company’s loans; iv) credit quality deterioration that could cause an increase in the provision for loan losses; v) Asset/Liability matching risks and liquidity risks; volatility and devaluation in the securities markets, vi) failure to comply with the regulatory agreements under which the Company is subject, vii) expected cost savings from recent acquisitions are not realized, and, viii) potential impairment of goodwill and other intangible assets. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

United Security Bancshares (the “Company” or “Holding Company") is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. United Security Bank (the “Bank”) is a wholly-owned bank subsidiary of the Company and was formed in 1987. References to the Company are references to United Security Bancshares (including the Bank). References to the Bank are to United Security Bank, while references to the Holding Company are to the parent-only, United Security Bancshares. The Company currently has eleven banking branches, which provide financial services in Fresno, Madera, Kern, and Santa Clara counties in the state of California.

Effective March 23, 2010, United Security Bancshares (the “Company”) and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a formal written agreement (the “Agreement”) with the Federal Reserve Bank of San Francisco. The Agreement was a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009 and is intended to improve the overall condition of the Bank through, among other things, increased Board oversight; formal plans to monitor and improve processes related to asset quality, liquidity, funds management, capital, and earnings; and the prohibition of certain actions that might reduce capital, including the distribution of dividends or the repurchase of the Company’s common stock. The Board of Directors and management believe that the Company is in compliance with the terms of the Agreement. (For more information on the Agreement see the “Regulatory Matters” section included in this Management’s Discussion and Analysis of Financial Condition and Results of Operations.)

During May of 2010, the California Department of Business Oversight (formerly known as the California Department of Financial Institutions) issued a written order (the “Order”) to the Bank as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Business Oversight in June 2009. The Order issued by the California Department of Business Oversight is similar to the written agreement with the Federal Reserve Bank of San Francisco. As of September 24, 2013, the Bank entered into a Memorandum of Understanding (the “MOU”) with the California Department of Business Oversight. Effective October 15, 2013, the Order was officially terminated by the California Department of Business Oversight. The Board of Directors and management believe that the Company is in compliance with the terms of the MOU. (For more information on the Agreement see the “Regulatory Matters” section included in this Management’s Discussion and Analysis of Financial Condition and

Results of Operations.)

Trends Affecting Results of Operations and Financial Position

The Company's overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact the results of operations, but also the composition of the Company's balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth. Net interest income before provision for credit losses has decreased between the three and nine months ended September 30, 2013 and 2012, totaling $5,427,000 for the three months ended September 30, 2013 as compared to $5,622,000 for the three months ended September 30, 2012, and $16,029,000 for the nine months ended September 30, 2013 as compared to $17,669,000 for the nine months ended September 30, 2012. The decrease

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in net interest income between 2012 and 2013 was primarily the result of a shift in the mix as well as a decline in the yield on interest-earning assets which outweighed the decrease in the Company's cost of funding between the two periods.

Average interest-earning assets increased approximately $27,650,000 between the nine month periods ended September 30, 2013 and 2012. Components of the $27,650,000 increase in average earning assets between 2012 and 2013 included a increase of $2,329,000 in loans and a $10,042,000 decrease in investment securities. More than offsetting these decreases between the comparative periods was an increase of $35,823,000 in overnight funds sold to the Federal Reserve Bank. During the past year, the Company's cost of interest-bearing liabilities have continued to decline, with the average cost of interest-bearing liabilities dropping from 0.62% during the nine months ended September 30, 2012, to 0.49% during the nine months ended September 30, 2013.

The following table summarizes the year-to-date averages of the components of interest-earning assets as a percentage of total interest-earning assets and the components of interest-bearing liabilities as a percentage of total interest-bearing liabilities:

	YTD Average 9/30/13	YTD Average 12/31/12	YTD Average 9/30/12
Loans and Leases	71.81%	74.20%	75.18%
Investment securities available for sale	4.99%	7.30%	7.19%
Interest-bearing deposits in other banks	0.28%	0.35%	0.38%
Interest-bearing deposits in FRB	22.92%	18.15%	17.25%
Total interest-earning assets	100.00%	100.00%	100.00%
NOW accounts	15.42%	14.44%	14.53%
Money market accounts	41.42%	37.39%	35.98%
Savings accounts	12.37%	11.99%	11.95%
Time deposits	27.71%	33.44%	35.00%
Other borrowings	0.00%	0.00%	0.00%
Subordinated debentures	3.08%	2.74%	2.54%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

The residential real estate markets in the five county region from Merced to Kern showed signs of improvement since 2012 and those trends continued into the third quarter of 2013. The severe declines in residential construction and home prices that began in 2008 continue to show signs of easing and reversing direction. The sustained period of double-digit price declines from 2008 – 2011 adversely impacted the Company's operations and increased the levels of nonperforming assets, increased expenses related to foreclosed properties, and decreased profit margins. As the Company continues its business development and expansion efforts throughout its market areas, a primary focus is reduction of nonperforming assets while providing customers options to work through this difficult economic period. Options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices improved in the five county region from Merced to Kern between September 2012 to September 2013. Total nonperforming loans decreased during the nine months ended September 30, 2013, totaling $21,605,000 at September 30, 2013 compared to $23,142,000 reported at December 31, 2012.

As a result of a modest improvement in the economy, the Company has experienced improvement in the loan portfolio between 2012 and 2013. During the nine months ended September 30, 2013, the Company experienced increases in real estate construction development and real estate mortgage loans, but experienced decreases in commercial and industrial loans, compared to the same period ended September 30, 2012. Loans decreased $16,027,000 between December 31, 2012 and September 30, 2013, and increased $7,953,000 between September 30, 2012 and

September 30, 2013. Commercial and industrial loans decreased $1,311,000 between December 31, 2012 and September 30, 2013 and decreased $53,432,000 between September 30, 2012 and September 30, 2013. Real estate mortgage loans increased $4,403,000 between December 31, 2012 and September 30, 2013, and $43,613,000 between September 30, 2012 and September 30, 2013. Agricultural loans decreased $11,189,000 between December 31, 2012 and September 30, 2013 and increased $2,102,000 between September 30, 2012 and September 30, 2013. Commercial real estate loans (a component of real estate mortgage loans) have remained as a significant percentage of total loans over the past year, amounting to 37.07%, 33.39%, and 33.17%, of the total loan portfolio at September 30, 2013, December 31, 2012, and September 30, 2012, respectively. Residential mortgage loans are not generally a large part of the Company’s loan portfolio, but some residential mortgage loans have been made over the past several years to

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facilitate take-out loans for construction borrowers when they were not able to obtain permanent financing elsewhere. These loans are generally 30-year amortizing loans with maturities of between three and five years. Residential mortgages totaled $50,502,000 or 13.15% of the portfolio at September 30, 2013, $55,016,000, or 13.75% of the portfolio at December 31, 2012, and $24,201,000 or 6.44% of the portfolio at September 30, 2012. Loan participations purchased have decreased from $2,170,000 or 0.58% of the portfolio at September 30, 2012, to $33,000 or 0.01% of the portfolio at December 31, 2012, to $30,000 or less than 0.01% of the portfolio at September 30, 2013. Loan participations sold decreased from $12,645,000 or 3.36% of the portfolio at September 30, 2012, to $12,117,000 or 3.0% of the portfolio at December 31, 2012, to $9,786,000, or 2.5%, at September 30, 2013.

Although market rates of interest are at historically low levels, the Company’s disciplined deposit pricing efforts have helped maintain adequate margins. The Company’s net interest margin decreased to 3.90% for the nine months ended September 30, 2013, when compared to 4.53% for the nine months ended September 30, 2012. The net interest margin has also been impacted by a decline in loans, the Company’s highest yielding asset, which has been partially offset by an increase in overnight investments with the Federal Reserve Bank, a much lower yielding asset. The Company has successfully sought to mitigate the low-interest rate environment with loan floors included in new and renewed loans when practical. Loans yielded 5.62% during the nine months ended September 30, 2013, as compared to 6.03% for the nine months ended September 30, 2012. The decrease in the Company’s cost of funds over the past year has mitigated the impact of declining yields on earning assets. The Company’s average cost of funds was 0.49% for the nine months ended September 30, 2013 as compared to 0.62% for the nine months ended September 30, 2012. Although the Company does not intend to increase its current level of brokered deposits, the levels of brokered deposits are expected to remain level at least in the short-term. The Company is currently only utilizing CDAR's reciprocal deposits as a concession to our customer. The $14,940,000 in brokered deposits at September 30, 2013 continues to provide the Company with a low-cost source of deposits. The Company will continue to utilize these funding sources when required to maintain prudent liquidity levels, while seeking to increase core deposits when possible.

Total noninterest income of $3,038,000 reported for the nine months ended September 30, 2013 decreased $1,917,000 or 38.69% as compared to the nine months ended September 30, 2012. Noninterest income continues to be driven by customer service fees, which totaled $2,554,000 for the nine months ended September 30, 2013. However, the decrease in noninterest income between the nine months ended September 30, 2013 and September 30, 2012, was primarily the result of a $1,807,000 decrease in gain on sale of other investments and a decrease of $235,000 due to a loss on fair value of financial liability, partially offset by an decrease of $284,000 on impairment losses on investment securities.

Noninterest expense decreased approximately $1,152,000 or 8.04% between the nine months ended September 30, 2012 and September 30, 2013. The decrease experienced during the nine months ended September 30, 2013 were primarily the result of a decrease of $1,274,000 in the net operating cost on OREO and a decrease in amortization expenses.

Effective March 31, 2009, and beginning with the quarterly interest payment due October 1, 2009, the Company deferred interest payments on the Company's $15.0 million of junior subordinated debentures relating to its trust preferred securities. This was the result of regulatory restraints which have precluded the Bank from paying dividends to the Holding Company. The Agreement with the Federal Reserve Bank entered into during March 2010 specifically prohibits the Company and the Bank from making any payments on the junior subordinated debt without prior approval of the Federal Reserve Bank. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals are elected, the Company will continue to record interest expense associated with the debentures. Upon the expiration of the deferral period, all accrued and unpaid interest will be due and payable. Under the terms of the debenture, the Company is precluded from paying cash dividends to shareholders or repurchasing its stock during the deferral period.

The Company has not paid any cash dividends on its common stock since the second quarter of 2008 and does not expect to resume cash dividends on its common stock for the foreseeable future. Because the Company has elected to defer the quarterly payments of interest on its junior subordinated debentures issued in connection with the trust preferred securities as discussed above, the Company is prohibited under the subordinated debenture agreement from paying cash dividends on its common stock during the deferral period. In addition, pursuant to the Agreement entered into with the Federal Reserve Bank during March of 2010, the Company and the Bank are precluded from paying cash dividends without prior consent of the Federal Reserve Bank. On September 24, 2013, the Company's Board of Directors declared a one-percent (1%) quarterly stock dividend on the Company's outstanding common stock. The Company believes, given the current uncertainties in the economy and unprecedented declines in real estate valuations in our markets, it is prudent to retain capital in this environment, and better position the Company for future growth opportunities. Based upon the number of outstanding common shares on the record date of October 11, 2013, an additional 145,061 shares were issued to shareholders.