SIERRA BANCORP
Form 10-Q
August 06, 2018
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2018

Commission file number: 000-33063

Sierra Bancorp

(Exact name of Registrant as specified in its charter)

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

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

Large Accelerated Filer		Accelerated Filer:
Non accelerated Filer:	(Do not check if a smaller reporting company)	Smaller Reporting Company:
Emerging Growth Company:		

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section7(a)(2)(B) of the Securities Act.

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

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, 15,263,080 shares outstanding as of August 1, 2018

FORM 10-Q

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PART I - FINANCIAL INFORMATION

Item 1 – Financial Statements

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

ASSETS	June 30, 2018 (unaudited)	December 31, 2017 (audited)
Cash and due from banks	$67,905	$61,142
Interest-bearing deposits in banks	17,197	8,995
Total cash & cash equivalents	85,102	70,137
Securities available-for-sale	559,968	558,329
Loans and leases:		
Gross loans and leases	1,624,344	1,557,820
Allowance for loan and lease losses	(9,136)	(9,043)
Deferred loan and lease costs, net	2,920	2,774
Net loans and leases	1,618,128	1,551,551
Foreclosed assets	2,112	5,481
Premises and equipment, net	30,182	29,388
Goodwill	27,357	27,357
Other intangible assets, net	6,919	6,234
Company owned life insurance	48,061	47,108
Other assets	47,614	44,713
Total assets	$2,425,443	$2,340,298
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$674,283	$635,434
Interest bearing	1,413,639	1,352,952
Total deposits	2,087,922	1,988,386
Repurchase agreements	17,239	8,150
Short-term borrowings	—	21,900
Subordinated debentures, net	34,677	34,588
Other liabilities	25,367	31,332
Total liabilities	2,165,205	2,084,356
Commitments and contingent liabilities (Note 8)		
Shareholders' equity		
Common stock, no par value; 24,000,000 shares authorized; 15,258,100 and 15,223,360 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	111,740	111,138
Additional paid-in capital	2,994	2,937
Retained earnings	154,020	144,197
Accumulated other comprehensive loss, net	(8,516)	(2,330)

Total shareholders' equity	260,238	255,942
Total liabilities and shareholder's equity	$2,425,443	$2,340,298

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

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

	Three months ended June 30,		Six months ended June 30,	
Interest and dividend income	2018	2017	2018	2017
Loans and leases, including fees	$21,504	$15,837	$41,508	$30,806
Taxable securities	2,300	2,147	4,638	4,160
Tax-exempt securities	1,018	932	2,034	1,737
Federal funds sold and other	61	139	180	255
Total interest income	24,883	19,055	48,360	36,958
Interest expense				
Deposits	1,594	868	2,912	1,557
Short-term borrowings	53	10	66	21
Subordinated debentures	436	337	822	657
Total interest expense	2,083	1,215	3,800	2,235
Net interest income	22,800	17,840	44,560	34,723
Provision for loan losses	300	300	500	300
Net interest income after provision for loan losses	22,500	17,540	44,060	34,423
Non-interest income				
Service charges on deposits	3,027	2,776	5,974	5,348
Net gains on sale of securities available-for-sale	—	58	—	66
Other income	2,402	2,530	4,589	5,084
Total non-interest income	5,429	5,364	10,563	10,498
Other operating expense				
Salaries and employee benefits	8,997	7,253	18,180	15,138
Occupancy and equipment	2,451	2,235	4,799	4,555
Other	5,846	5,603	12,202	11,099
Total other operating expense	17,294	15,091	35,181	30,792
Income before taxes	10,635	7,813	19,442	14,129
Provision for income taxes	2,643	2,611	4,740	4,375
Net income	$7,992	$5,202	$14,702	$9,754
PER SHARE DATA				
Book value	$17.06	$15.62	$17.06	$15.62
Cash dividends	$0.16	$0.14	$0.32	$0.28
Earnings per share basic	$0.52	$0.38	$0.96	$0.71
Earnings per share diluted	$0.52	$0.37	$0.95	$0.70
Average shares outstanding, basic	15,254,575	13,831,345	15,243,697	13,816,576
Average shares outstanding, diluted	15,429,129	14,010,328	15,420,886	14,009,485
Total shareholder equity (in thousands)	$260,238	$216,123	$260,238	$216,123
Shares outstanding	15,258,100	13,832,549	15,258,100	13,832,549
Dividends paid (in thousands)	$2,441	$1,936	$4,878	$3,867

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands, unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Net income (loss)	$7,992	$5,202	$14,702	$9,754
Other comprehensive income, before tax:				
Unrealized (losses) gains on securities:				
Unrealized holding (loss) gain arising during period	(1,192)	4,368	(8,784)	5,778
Less: reclassification adjustment for gains included in net income [1]	—	(58)	—	(66)
Other comprehensive (loss) income, before tax	(1,192)	4,310	(8,784)	5,712
Income tax expense related to items of other comprehensive income (loss), net of tax	353	(1,812)	2,598	(2,402)
Other comprehensive (loss) income	(839)	2,498	(6,186)	3,310
Comprehensive income	$7,153	$7,700	$8,516	$13,064

[1] Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended June 30, 2018 and 2017 was $0 and $3 thousand respectively. Income tax expense associated with the reclassification adjustment for the six months ended June 30, 2018 and 2017 was $0 and $28 thousand respectively.

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Six months ended June 30, 2018	2017
Cash flows from operating activities:		
Net income	$ 14,702	$ 9,754
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of securities	—	(66)
Loss on disposal of fixed assets	13	2
Gain on sale on foreclosed assets	(713)	(12)
Writedowns on foreclosed assets	176	75
Share-based compensation expense	174	441
Provision for loan losses	500	300
Depreciation and amortization	1,566	1,462
Net amortization on securities premiums and discounts	2,904	3,433
Accretion of discounts for loans acquired	(911)	(550)
Increase in cash surrender value of life insurance policies	(626)	(1,109)
Amortization of core deposit intangible	484	213
Increase in interest receivable and other assets	(1,020)	(3,907)
(Decrease) increase in other liabilities	(5,965)	185
	(962)	133

Deferred income tax (benefit) provision				
Net amortization of partnership investment	810		—	
Net cash provided by operating activities	11,132		10,354	
Cash flows from investing activities:				
Maturities of securities available for sale	1,390		—	
Proceeds from sales/calls of securities available for sale	920		17,625	
Purchases of securities available for sale	(61,999	)	(114,633	)
Principal pay downs on securities available for sale	46,363		49,856	
Net purchases of FHLB stock	(301	)	(235	)
Loan originations and payments, net	(66,185	)	(36,851	)
Purchases of premises and equipment, net	(2,284	)	(920	)
Proceeds from sales of foreclosed assets	3,925		99	
Purchase of company owned life insurance	(327	)	—	
Net cash from bank acquisition	(6	)		
Net cash used in investing activities	(78,504	)	(85,059	)
Cash flows from financing activities:				
Increase in deposits	99,536		96,386	
Decrease in borrowed funds	(21,900	)	(65,000	)
Increase in repurchase agreements	9,089		3,202	
Cash dividends paid	(4,878	)	(3,867	)
Stock options exercised	490		717	
Net cash provided by financing activities	82,337		31,438	

Increase (decrease) in cash and due from banks		14,965		(43,267	)
Cash and cash equivalents					
Beginning of period		70,137		120,442	
End of period	$	85,102	$	77,175	

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

Sierra Bancorp

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(Unaudited)

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of June 30, 2018, the Company's only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which were formed solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). Pursuant to the Financial Accounting Standards Board ("FASB") standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the Company's financial statements. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

Bank of the Sierra, a California state-chartered bank headquartered in Porterville, California, offers a full range of retail and commercial banking services via branch offices located throughout California's South San Joaquin Valley, the Central Coast, Ventura County, and neighboring communities. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with $1.5 million in capital. Our growth in the ensuing years has largely been organic in nature, but includes four whole-bank acquisitions: Sierra National Bank in 2000, Santa Clara Valley Bank in 2014, Coast National Bank in 2016, and Ojai Community Bank in October 2017. Details on our most recent acquisitions are provided in Note 14 to the consolidated financial statements. We also acquired a branch located in Lompoc, California from Community Bank of Santa Maria on May 18, 2018, and plan to open a new branch on Palm Avenue in Fresno in the third quarter of 2018. As of the filing date of this report the Bank operates 39 full service branches and an online branch, and maintains ATMs at all branch locations and seven non-branch locations. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. The Company's total assets exceeded $2.4 billion at June 30, 2018, and for the past several years we have claimed the distinction of being the largest bank headquartered in the South San Joaquin Valley. The Bank's deposit accounts, which totaled close to $2.1 billion at June 30, 2018, are insured by the Federal Deposit Insurance Corporation ("FDIC") up to maximum insurable amounts.

Note 2 – Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of Management, necessary for a fair statement of the results for such periods. Such adjustments can generally be considered as normal and recurring unless otherwise disclosed in this Form 10-Q. In preparing the accompanying financial statements, Management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2017 have been reclassified to be consistent with the reporting for 2018. The interim financial information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission (the "SEC").

Note 3 – Current Accounting Developments

In May 2014 the FASB issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is the result of a joint project initiated by the FASB and the International Accounting Standards Board ("IASB") to clarify the principles for recognizing revenue, and to develop common revenue standards and disclosure requirements that would: (1) remove inconsistencies and weaknesses in revenue requirements; (2) provide a more robust framework for addressing revenue issues; (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; (4) provide more useful information to users of financial statements through improved disclosures; and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required with regard to contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The guidance does not apply to revenue associated with financial instruments such as loans and investments, which is accounted for under other provisions of GAAP. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein, and the Company thus adopted ASU 2014-09 on January 1, 2018 utilizing the modified retrospective approach. The Company's primary source of revenue is derived from income on financial instruments, which is not impacted by the guidance in ASU 2014-09. Furthermore, the Company has evaluated the nature of its non-interest income and determined that for income associated with customer contracts, transaction prices are typically fixed and performance obligations are satisfied as services are rendered. Therefore, there is little or no judgment involved in the timing of revenue recognition under contracts within the scope of ASU 2014-09, and there was no impact on our financial statements upon the adoption of ASU 2014-09. Please see Note 13 to the consolidated financial statements for more detailed disclosure information.

In January 2016 the FASB issued ASU 2016-01, Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. This guidance primarily affects the accounting for equity securities with readily determinable fair values, by requiring that the changes in fair value for such securities will be reflected in earnings rather than in other comprehensive income. The accounting for other financial instruments such as loans, debt securities, and financial liabilities is largely unchanged. ASU 2016-01 also changes the presentation and disclosure requirements for financial instruments, including a requirement that public business entities use exit pricing when estimating fair values for financial instruments measured at amortized cost for disclosure purposes. ASU 2016-01 is generally effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU 2016-01 on January 1, 2018. We had no equity positions with readily determinable market values at any point in the first half of 2018, thus that aspect of the guidance did not impact our financial statements, but our fair value disclosures for financial instruments were adjusted to reflect exit pricing where such was not already incorporated.

In February 2016 the FASB issued ASU 2016-02, Leases (Topic 842). The intention of this standard is to increase the transparency and comparability around lease obligations. Previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet, accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements. ASU 2016-02 is generally effective for public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company has leases on 21 branch locations and an administrative office building, which are considered operating leases and are not currently reflected in our financial statements. We expect that these lease agreements will be recognized on our consolidated statement of condition as right-of-use assets and corresponding lease liabilities subsequent to implementing ASU 2016-02, but we are still evaluating the extent to which this will impact our consolidated financial statements.

In March 2016 the FASB issued ASU 2016-09, Compensation–Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, as part of its simplification initiative. ASU 2016-09 became effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. Accordingly, the Company adopted ASU 2016-09 effective January 1, 2017. Prior guidance dictated that as they relate to share-based payments, tax benefits in excess of compensation costs ("windfalls") were to be recorded in equity, and tax deficiencies ("shortfalls") were to be recorded in equity to the extent of previous windfalls and then to the income statement. ASU 2016-09 reduced some of the administrative complexities by eliminating the need to track a windfall "pool," but it increases the volatility of income tax expense. ASU 2016-09 also removed the requirement to delay recognition of a windfall tax benefit until such time as it reduces current taxes payable. Under the new guidance, the benefit is recorded when it arises, subject to normal valuation allowance considerations. This change was applied by us on a modified retrospective basis, as required, with a cumulative-effect adjustment to opening retained earnings. Furthermore, all tax-related cash flows resulting from share-based payments are now reported as operating activities on the statement of cash flows, a change from the previous requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. However, cash paid by an employer when directly withholding shares for tax withholding purposes is classified as a financing activity. Under the new guidance, entities were permitted to make an accounting policy election for the impact of forfeitures on expense recognition for share-based payment awards. Forfeitures can be estimated in advance, as required previously, or recognized as they occur. Estimates are still required in certain circumstances, such as at the time of modification of an award or issuance of a replacement award in a business combination. If elected, the change to recognize forfeitures when they occur would have been adopted using a modified retrospective approach, with a cumulative effect adjustment recorded to opening retained earnings. We did not elect to recognize forfeitures as they occur, and continue to estimate potential forfeitures in advance.

In September 2016 the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which eliminates the probable initial recognition threshold for credit losses in current U.S. GAAP, and instead requires an organization to record a current estimate of all expected credit losses over the contractual term for financial assets carried at amortized cost. This is commonly referred to as the current expected credit losses ("CECL") methodology. Expected credit losses for financial assets held at the reporting date will be measured based on historical experience, current conditions, and reasonable and supportable forecasts. Another change from existing U.S. GAAP involves the treatment of purchased credit deteriorated assets, which are more broadly defined than purchased credit impaired assets in current accounting standards. When such assets are purchased, institutions will estimate and record an allowance for credit losses that is added to the purchase price rather than being reported as a credit loss expense. Furthermore, ASU 2016-13 updates the measurement of credit losses on available-for-sale debt securities, by mandating that institutions record credit losses on available-for-sale debt securities through an allowance for credit losses rather than the current practice of writing down securities for other-than-temporary impairment. ASU 2016-13 will also require the enhancement of financial statement disclosures regarding estimates used in calculating credit losses. ASU 2016-13 does not change the existing write-off principle in U.S. GAAP or current nonaccrual practices, nor does it change accounting requirements for loans held for sale or certain other financial assets which are measured at the lower of amortized cost or fair value. As a public business entity that is an SEC filer, ASU 2016-13 becomes effective for the Company on January 1, 2020, although early application is permitted for 2019. On the effective date, institutions will apply the new accounting standard as follows: for financial assets carried at amortized cost, a cumulative-effect adjustment will be recognized on the balance sheet for any change in the related allowance for loan and lease losses generated by the adoption of the new standard; financial assets classified as purchased credit impaired assets prior to the effective date will be reclassified as purchased credit deteriorated assets as of the effective date, and will be grossed up for the related allowance for expected credit losses created as of the effective date; and, debt securities on which other-than-temporary impairment had been recognized prior to the effective date will transition to the new guidance prospectively with no change in their amortized cost basis. The Company is well under way with transition efforts. We have established an implementation team which is chaired by our Chief Credit Officer and includes the Company's other executive officers, along with certain members of our credit administration and finance departments. Furthermore, after extensive discussion and due diligence, we engaged an external vendor to assist in our calculation of potential required reserves utilizing the CECL methodology and to help validate our current reserving methodology. A preliminary evaluation indicates that the provisions of ASU 2016-13 will likely have a material impact on our consolidated financial statements, particularly the level of our allowance for credit losses and shareholders' equity. While the potential extent of that impact has not yet been definitively determined, initial estimates indicate that our allowance for loan and lease losses could increase by 100% or more relative to current levels if utilizing a discounted cash flow methodology with forecasting.

In January 2017 the FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. Currently, Topic 805 specifies three elements of a business – inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes. This led many transactions to be accounted for as business combinations rather than asset purchases under legacy GAAP. The primary goal of ASU 2017-01 is to narrow the definition of a business, and the guidance in this update provides a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and we implemented ASU 2017-01 on a prospective basis effective January 1, 2018. This update affected the accounting treatment used for our branch purchase in the second quarter of 2018, and we expect that it will impact the way we account for some branch acquisitions in future periods, as well.

In January 2017 the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment. This guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation, and goodwill impairment will simply be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. The same one-step impairment test will be applied to goodwill at all reporting units, even those with zero or negative carrying amounts. Entities will be required to disclose the amount of goodwill at reporting units with zero or negative carrying amounts. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2019. We have not been required to record any goodwill impairment to date, and after a preliminary review do not expect that this guidance would require us to do so given current circumstances. Nevertheless, we will continue to evaluate ASU 2017-04 to more definitely determine its potential impact on the Company's consolidated financial position, results of operations and cash flows.

In March 2017 the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The amendments in this update will shorten the amortization period for certain callable debt securities held at a premium, by requiring the premium to be amortized to the earliest call date. Under current guidance, the premium on a callable debt security is generally amortized as an adjustment to yield over the contractual life of the instrument, and any unamortized premium is recorded as a loss in earnings upon the debtor's exercise of a call provision. Under ASU 2017-08, because the premium will be amortized to the earliest call date, entities will no longer recognize a loss in earnings if a debt security is called prior to the contractual maturity date. The amendments do not require an accounting change for securities held at a discount; discounts will continue to be amortized as an adjustment to yield over the contractual life of the debt instrument. ASU 2017-08 is effective for public business entities, including the Company, for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period. To apply ASU 2017-08, entities must use a modified retrospective approach, with the cumulative-effect adjustment recognized to retained earnings at the beginning of the period of adoption. Entities are also required to provide disclosures about a change in accounting principle in the period of adoption. The Company has evaluated the potential impact of this guidance, and does not expect the adoption of ASU 2017-08 to have a material impact on our financial statements or operations.

In May 2017 the FASB issued ASU 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting. This update was issued to provide clarity, reduce diversity in practice, and lower cost and complexity when applying the guidance in Topic 718. Under the updated guidance, an entity will be expected to account for the effects of an equity award modification unless all the following are met: 1) the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified; 2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; 3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. The current disclosure requirements in Topic 718 continue to apply. ASU 2017-09 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company adopted this guidance effective January 1, 2018, but since we have not modified equity awards in the past and do not expect to do so in the future, there was no impact on our financial statements or operations from the adoption of ASU 2017-09.

In February 2018 the FASB issued ASU 2018-02, Income Statement–Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This ASU requires a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the lower corporate income tax rate authorized by the Tax Cuts and Jobs Act of 2017 ("Tax Act"). The Tax Act was enacted on December 22, 2017, and included a reduction in the maximum Federal corporate income tax rate from 35 percent to 21 percent effective January 1, 2018. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, but early adoption is permitted. The Company adopted the guidance for the first quarter of 2018, retrospectively to December 31, 2017. The change in accounting principle was accounted for as a cumulative-effect adjustment to our balance sheet, resulting in a $413 thousand increase to retained earnings and a corresponding decrease to AOCI on December 31, 2017.

In February 2018 the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments–Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This new guidance relates to ASU 2016-01, which provides for a measurement alternative for certain equity investments that do not have readily determinable fair values. ASU 2018-03 allows a company to change its measurement approach for such equity investments to the “fair value through current earnings” method. However, once a company makes this election for a particular investment it must apply the “fair value through current earnings” model to all identical investments and/or similar investments from the same issuer. Furthermore, a company cannot elect the measurement alternative for future purchases of identical or similar investments of the same issuer. The new guidance also clarifies the following: when applying the measurement alternative to equity investments that do not have a readily determinable fair value, in the event there is an observable price/transaction for a similar instrument from the same issuer, the objective is to re-measure the equity investment to its fair value as of the date of the observable price/transaction; for forward and option contracts measured under the alternative, when there is an observable price/transaction or impairment of the underlying equity instrument the contract should be re-measured to its fair value; and, the presentation guidance requiring the portion of the total change in fair value that results from changes in instrument-specific credit risk to be reported in accumulated other comprehensive income applies when the fair value option is elected under either ASC 825, Financial Instruments, or ASC 815, Derivatives and Hedging. The amendments also clarify the interaction between the instrument-specific credit risk guidance in ASC 825 and the foreign currency guidance in ASC 830. The transition provisions of ASU 2016-01 generally require a modified retrospective approach, but they specify prospective transition for equity investments without a readily determinable fair value. The new guidance amends the transition provisions such that only equity investments without a readily determinable fair value for which a company elects the measurement alternative will be subject to prospective transition guidance. The new guidance is not required to be adopted concurrent with ASU 2016-01 on January 1, 2018, but given that it amends the transition guidance in ASU 2016-1, concurrent adoption is permitted. The new guidance must be adopted no later than the third quarter of 2018 (an interim period). The Company elected to adopt ASU 2018-03 effective January 1, 2018, which did not impact our financial statements because we did not change our measurement approach for equity instruments that do not have readily determinable fair values.

Note 4 – Supplemental Disclosure of Cash Flow Information

During the six months ended June 30, 2018 and 2017, cash paid for interest due on interest-bearing liabilities was $3.914 million and $2.273 million, respectively. There was $10.000 million in cash paid for income taxes during the six months ended June 30, 2018, and $5.647 million during the six months ended June 30, 2017. There was $19,000 in assets acquired in settlement of loans for the six months ended June 30, 2018, relative to $115,000 during the six months ended June 30, 2017. We received $3.925 million in cash from the sale of foreclosed assets during the first six months of 2018 relative to $99,000 during the first six months of 2017, which represents sales proceeds less loans (if any) extended to finance such sales.

Note 5 – Share Based Compensation

On March 16, 2017 the Company's Board of Directors approved and adopted the 2017 Stock Incentive Plan (the "2017 Plan"), which became effective May 24, 2017, the date approved by the Company's shareholders. The 2017 Plan replaced the Company's 2007 Stock Incentive Plan (the "2007 Plan"), which expired by its own terms on March 15, 2017. Options to purchase 412,580 shares that were granted under the 2007 Plan were still outstanding as of June 30, 2018, and remain unaffected by that plan's expiration. The 2017 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors and consultants of the Company. The 2017 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, although no restricted stock awards have ever been issued by the Company. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2017 Plan was initially 850,000 shares, and the number remaining available for grant as of June 30, 2018 was 767,000. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share.

Pursuant to FASB's standards on stock compensation, the value of each stock option granted is reflected in our income statement as employee compensation or directors' expense by expensing its fair value as of the grant date in the case of immediately vested options, or by amortizing its grant date fair value over the vesting period for options with graded vesting. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee's options for each vesting period are separately valued and amortized. A pre-tax charge of $98,000 was reflected in the Company's income statement during the second quarter of 2018 and $18,000 was charged during the second quarter of 2017, as expense related to stock options. For the first half, the charges totaled $174,000 in 2018 and $441,000 in 2017.

Note 6 – Earnings per Share

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 15,254,575 weighted average shares outstanding during the second quarter of 2018, and 13,831,345 during the second quarter of 2017. There were 15,243,697 weighted average shares outstanding during the first six months of 2018, and 13,816,576 during the first six months of 2017.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of "in-the-money" stock options. For the second quarter of 2018, calculations under the treasury stock method resulted in the equivalent of 174,554 shares being added to basic weighted average shares outstanding for purposes of determining diluted earnings per share, while a weighted average of 106,200 stock options were excluded from the calculation because they were underwater and thus anti-dilutive. For the second quarter of 2017 the equivalent of 178,983 shares were added in calculating diluted earnings per share, while 120,700 anti-dilutive stock options were not factored into the computation. Likewise, for the first half of 2018 the equivalent of 177,189 shares were added to basic weighted average shares outstanding in calculating diluted earnings per share and a weighted average of 166,200 stock options that were anti-dilutive for the period were not included, compared to the addition of the equivalent of 192,909 shares and non-inclusion of 120,700 anti-dilutive options in calculating diluted earnings per share for first half of 2017.

Note 7 – Comprehensive Income

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

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

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

	June 30, 2018	December 31, 2017
Commitments to extend credit	$727,714	$691,712
Standby letters of credit	$10,186	$9,168

Commitments to extend credit consist primarily of the unused or unfunded portions of the following: home equity lines of credit; commercial real estate construction loans, where disbursements are made over the course of construction; commercial revolving lines of credit; mortgage warehouse lines of credit; unsecured personal lines of credit; and formalized (disclosed) deposit account overdraft lines. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many commitments are expected to expire without being drawn upon, the unused portions of committed amounts do not necessarily represent future cash requirements. Standby letters of credit are issued by the Company to guarantee the performance of a customer to a third party, and the credit risk involved in issuing letters of credit is essentially the same as the risk involved in extending loans to customers.

At June 30, 2018, the Company was also utilizing a letter of credit in the amount of $96 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

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

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

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

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. Fair value disclosures for deposits include demand deposits, which are by definition equal to the amount payable on demand at the reporting date. As discussed in Note 3 to the consolidated financial statements, we adopted ASU 2016-01 for the first quarter of 2018, thus fair value calculations for loans and leases at June 30, 2018 reflect exit pricing, and incorporate our assumptions with regard to the impact of prepayments on future cash flows and credit quality adjustments based on risk characteristics of various financial instruments, among other things. This is not entirely comparable with fair values disclosed as of December 31, 2017, which were estimated primarily by discounting estimated cash flows at current market interest rates (entry pricing). The estimates at both dates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly alter the fair values presented.

Estimated fair values for the Company's financial instruments are as follows, as of the dates noted:

Fair Value of Financial Instruments
(dollars in thousands, unaudited)

	June 30, 2018				
		Fair Value Measurements			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$85,102	$85,102	$—	$ —	$85,102
Investment securities available for sale	559,968	—	559,968	—	559,968
Loans and leases, net held for investment	1,618,033	—	1,586,555	—	1,586,555
Collateral dependent impaired loans	95	—	95	—	95
Financial liabilities:					
Deposits	2,087,922	674,283	1,413,133	—	2,087,416
Subordinated debentures	34,677	—	28,897	—	28,897

December 31, 2017

	Carrying Amount	Fair Value Measurements: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$70,137	$70,141	$—	$ —	$70,141
Investment securities available for sale	558,329	—	558,329	—	558,329
Loans and leases, net held for investment	1,551,174	—	1,563,765	—	1,563,765
Collateral dependent impaired loans	377	—	377	—	377
Financial liabilities:					
Deposits	1,988,386	635,434	1,352,740	—	1,988,174
Subordinated debentures	34,588	—	24,216	—	24,216

For financial asset categories that were carried on our balance sheet at fair value as of June 30, 2018 and December 31, 2017, the Company used the following methods and significant assumptions:

- Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.
- Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.
- Foreclosed assets: Repossessed real estate (known as other real estate owned, or "OREO") and other foreclosed assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes; fair values for any other foreclosed assets are represented by estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

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

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

Fair Value Measurements at June 30, 2018, using

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss) (Level 3)
Securities:					
US Government agencies	$—	$ 17,914	$ —	$ 17,914	$ —
Mortgage-backed securities	—	399,867	—	399,867	—
State and political subdivisions	—	142,187	—	142,187	—
Total available-for-sale securities	$—	$ 559,968	$ —	$ 559,968	$ —

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	Fair Value Measurements at December 31, 2017, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss) (Level 3)
Securities:					
US Government agencies	$—	$ 21,326	$ —	$21,326	$ —
Mortgage-backed securities	—	393,802	—	393,802	—
State and political subdivisions	—	143,201	—	143,201	—
Total available-for-sale securities	$—	$ 558,329	$ —	$558,329	$ —

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

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

	Fair Value Measurements at June 30, 2018, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real estate:				
1-4 family residential construction	$—	$ —	$ —	$—
Other construction/land	—	—	—	—
1-4 family - closed-end	—	2	—	2
Equity lines	—	53	—	53
Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Commercial real estate - non-owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate	—	55	—	55
Agricultural	—	—	—	—
Commercial and industrial	—	—	—	—
Consumer loans	—	40	—	40
Total impaired loans	$—	$ 95	$ —	$95

Foreclosed assets	$—	$ 2,112	$ —	$2,112
Total assets measured on a nonrecurring basis	$—	$ 2,207	$ —	$2,207

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	Fair Value Measurements at December 31, 2017, using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real estate:				
1-4 family residential construction	$—	$ —	$ —	$—
Other construction/land	—	—	—	—
1-4 family - closed-end	—	252	—	252
Equity lines	—	70	—	70
Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Commercial real estate - non-owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate	—	322	—	322
Agricultural	—	—	—	—
Commercial and industrial	—	—	—	—
Consumer loans	—	55	—	55
Total impaired loans	$—	$ 377	$ —	$377
Foreclosed assets	$—	$ 5,481	$ —	$5,481
Total assets measured on a nonrecurring basis	$—	$ 5,858	$ —	$5,858

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

The unobservable inputs are based on Management's best estimates of appropriate discounts in arriving at fair market value. Adjusting any of those inputs could result in a significantly lower or higher fair value measurement. For example, an increase or decrease in actual loss rates would create a directionally opposite change in the fair value of unsecured impaired loans.

Note 10 – Investments

Investment Securities

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

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

Amortized Cost And Estimated Fair Value
(dollars in thousands, unaudited)

	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
US Government agencies	$18,413	$ 5	$ (504)	$ 17,914
Mortgage-backed securities	411,822	326	(12,281)	399,867
State and political subdivisions	141,824	1,348	(985)	142,187
Total securities	$572,059	$ 1,679	$ (13,770)	$ 559,968

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	December 31, 2017			
		Gross	Gross	
	Amortized	Unrealized	Unrealized	Estimated Fair
	Cost	Gains	Losses	Value
US Government agencies	$21,524	$ 70	$ (268)	$ 21,326
Mortgage-backed securities	399,203	816	(6,217)	393,802
State and political subdivisions	140,909	2,673	(381)	143,201
Total securities	$561,636	$ 3,559	$ (6,866)	$ 558,329

At June 30, 2018 and December 31, 2017, the Company had 553 securities and 396 securities, respectively, with gross unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the unrealized losses are other than temporary. Gross unrealized losses on our investment securities as of the indicated dates are disclosed in the table below, categorized by investment type and by the duration of time that loss positions on individual securities have continuously existed (over or under twelve months).

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

	June 30, 2018			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$(176)	$9,486	$(328)	$7,964
Mortgage-backed securities	(4,741)	196,165	(7,540)	182,978
State and political subdivisions	(533)	47,293	(452)	11,577
Total	$(5,450)	$252,944	$(8,320)	$202,519

	December 31, 2017			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$(79)	$8,154	$(189)	$7,100
Mortgage-backed securities	(2,420)	188,885	(3,797)	158,344
State and political subdivisions	(89)	16,218	(292)	11,562
Total	$(2,588)	$213,257	$(4,278)	$177,006

The table below summarizes the Company's gross realized gains and losses as well as gross proceeds from the sales of securities, for the periods indicated:

Investment Portfolio - Realized Gains/(Losses)
(dollars in thousands, unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Proceeds from sales, calls and maturities of securities available for sale	$2,110	$4,721	$2,310	$17,625
Gross gains on sales, calls and maturities of securities available for sale	$—	$63	$—	$106
Gross losses on sales, calls and maturities of securities available for sale	—	(5)	—	(40)

Net gains on sale of securities available for sale	$—	$58	$—	$66

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The amortized cost and estimated fair value of investment securities available-for-sale at June 30, 2018 and December 31, 2017 are shown below, grouped by the remaining time to contractual maturity dates. The expected life of investment securities may not be consistent with contractual maturity dates, since the issuers of the securities might have the right to call or prepay obligations with or without penalties.

Estimated Fair Value of Contractual Maturities
(dollars in thousands, unaudited)

	June 30, 2018	
	Amortized Cost	Fair Value
Maturing within one year	$12,026	$12,092
Maturing after one year through five years	216,653	212,031
Maturing after five years through ten years	53,781	53,424
Maturing after ten years	75,486	75,189
Securities not due at a single maturity date:		
US Government agencies collateralized by mortgage obligations	214,113	207,232
	$572,059	$559,968

	December 31, 2017	
	Amortized Cost	Fair Value
Maturing within one year	$8,991	$9,085
Maturing after one year through five years	235,714	234,381
Maturing after five years through ten years	45,075	45,645
Maturing after ten years	76,471	77,423
Securities not due at a single maturity date:		
US Government agencies collateralized by mortgage obligations	195,385	191,795
	$561,636	$558,329

At June 30, 2018, the Company’s investment portfolio included 339 “muni” bonds issued by government municipalities and agencies located within 31 different states, with an aggregate fair value of $142 million. The largest exposure to any single municipality or agency was a combined $2.540 million (fair value) in general obligation bonds issued by the Lindsay (CA) Unified School District.

The Company’s investments in bonds issued by states, municipalities and political subdivisions are evaluated in accordance with Supervision and Regulation Letter 12-15 issued by the Board of Governors of the Federal Reserve System, “Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings,” and other regulatory guidance. Credit ratings are considered in our analysis only as a guide to the historical default rate associated with similarly-rated bonds. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.

The following table summarizes the amortized cost and fair values of general obligation and revenue bonds in the Company’s investment securities portfolio at the indicated dates, identifying the state in which the issuing municipality or agency operates for our largest geographic concentrations:

Revenue and General Obligation Bonds by Location
(dollars in thousands, unaudited)

	June 30, 2018		December 31, 2017	
General obligation bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
State of issuance				
Texas	$34,422	$34,254	$32,824	$33,184
California	27,236	27,696	27,205	28,027
Washington	13,741	13,762	13,282	13,524
Ohio	9,864	9,824	9,917	9,978
Illinois	8,803	8,810	8,822	8,925
Other (21 states)	23,714	23,789	24,591	24,971
Total general obligation bonds	117,780	118,135	116,641	118,609
Revenue bonds				
State of issuance				
Texas	7,055	7,053	7,088	7,172
Utah	5,381	5,365	5,397	5,454
Indiana	2,653	2,665	2,664	2,721
Washington	1,758	1,780	1,764	1,811
Virginia	1,602	1,567	1,613	1,626
Other (12 states)	5,595	5,622	5,742	5,808
Total revenue bonds	24,044	24,052	24,268	24,592
Total obligations of states and political subdivisions	$141,824	$142,187	$140,909	$143,201

The revenue bonds in the Company’s investment securities portfolios were issued by government municipalities and agencies to fund public services such as utilities (water, sewer, and power), educational facilities, and general public and economic improvements. The primary sources of revenue for these bonds are delineated in the table below, which shows the amortized cost and fair market values for the largest revenue concentrations as of the indicated dates.

Revenue Bonds by Type
(dollars in thousands, unaudited)

	June 30, 2018		December 31, 2017	
Revenue bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Revenue source:				
Water	$6,466	$6,450	$5,160	$5,230
Sales Tax	2,944	2,917	4,375	4,417
College & University	2,597	2,632	3,649	3,715

Lease	2,309	2,327	3,657	3,706
Sewer	1,402	1,411	582	581
Local or GTD Housing	1,352	1,317	2,076	2,116
Other (12 sources)	6,974	6,998	4,769	4,827
Total revenue bonds	$24,044	$24,052	$24,268	$24,592

Low-Income Housing Tax Credit (“LIHTC”) Fund Investments

The Company has the ability to invest in limited partnerships which own housing projects that qualify for federal and/or California state tax credits, by mandating a specified percentage of low-income tenants for each project. The tax credits flow through to investors, supplementing any returns that might be derived from an increase in property values. Because rent levels are lower than standard market rents and the projects are generally highly leveraged, each project also typically generates tax-deductible operating losses that are allocated to the limited partners.

The Company made investment commitments to nine different LIHTC fund limited partnerships from 2001 through 2017, all of which were California-focused funds that help the Company meet its obligations under the Community Reinvestment Act. We utilize the cost method of accounting for our LIHTC fund investments, under which we initially record on our balance sheet an asset that represents the total cash expected to be invested over the life of the partnership. Any commitments or contingent commitments for future investment are reflected as a liability. The income statement reflects tax credits and any other tax benefits from these investments “below the line” within our income tax provision, while the initial book value of the investment is amortized on a straight-line basis as an offset to non-interest income, over the time period in which the tax credits and tax benefits are expected to be received.

As of June 30, 2018 our total LIHTC investment book balance was $7.6 million, which includes $2.8 million in remaining commitments for additional capital contributions. There were $319,000 in tax credits derived from our LIHTC investments that were recognized during the six months ended June 30, 2018, and amortization expense of $810,000 associated with those investments was netted against pre-tax non-interest income for the same time period. Our LIHTC investments are evaluated annually for potential impairment, and we have concluded that the carrying value of the investments is stated fairly and is not impaired.

Note 11 – Credit Quality and Nonperforming Assets

Credit Quality Classifications

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

- Pass: Larger non-homogeneous loans not meeting the risk rating definitions below, and smaller homogeneous loans that are not assessed on an individual basis.
- Special mention: Loans which have potential issues that deserve the close attention of Management. If left uncorrected, those potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company’s credit position at some future date.
- Substandard: Loans that have at least one clear and well-defined weakness that could jeopardize the ultimate recoverability of all principal and interest, such as a borrower displaying a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or an otherwise deteriorated financial condition.
- Impaired: A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans and restructured troubled debt (“TDRs”). A TDR may be nonperforming or performing, depending on its accrual status and the demonstrated ability of the borrower to comply with restructured terms (see “Troubled Debt Restructurings” section below for additional information on TDRs).

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

Credit Quality Classifications

(dollars in thousands, unaudited)

	June 30, 2018				
		Special			
	Pass	Mention	Substandard	Impaired	Total
Real estate:					
1-4 family residential construction	$86,402	$—	$ —	$—	$86,402
Other construction/land	89,077	238	—	489	89,804
1-4 family - closed end	224,356	1,465	1,209	3,840	230,870
Equity lines	51,315	2,119	164	5,053	58,651
Multi-family residential	43,338	—	—	381	43,719
Commercial real estate - owner occupied	260,345	4,847	2,359	889	268,440
Commercial real estate - non-owner occupied	410,246	3,351	3,859	1,499	418,955
Farmland	140,208	738	497	32	141,475
Total real estate	1,305,287	12,758	8,088	12,183	1,338,316
Agricultural	52,719	620	—	—	53,339
Commercial and industrial	115,273	9,808	653	1,976	127,710
Mortgage warehouse	95,645	—	—	—	95,645
Consumer loans	8,271	210	40	813	9,334
Total gross loans and leases	$1,577,195	$23,396	$ 8,781	$14,972	$1,624,344

	December 31, 2017				
		Special			
	Pass	Mention	Substandard	Impaired	Total
Real estate:					
1-4 family residential construction	$74,256	$—	$ —	$—	$74,256
Other construction/land	57,421	807	—	551	58,779
1-4 family - closed end	197,309	1,534	1,204	4,719	204,766
Equity lines	53,825	3,620	521	4,624	62,590
Multi-family residential	42,539	—			