

ALLIED MOTION TECHNOLOGIES INC
Form 10-Q
August 06, 2015
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**UNITED STATES
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, 2015

Commission File Number

0-04041

ALLIED MOTION TECHNOLOGIES INC.

(Exact name of Registrant as Specified in Its Charter)

Colorado
(State or other jurisdiction of
incorporation or organization)

84-0518115
(I.R.S. Employer
Identification No.)

495 Commerce Drive, Suite 3

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Amherst, New York 14228

(Address of Principal Executive offices, including zip code)

(716) 242-8634

(Registrant's Telephone Number, Including Area Code)

(Former Address, 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 ninety (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 (§ 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 No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Number of Shares of the only class of Common Stock outstanding: 9,290,895 as of August 6, 2015

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ALLIED MOTION TECHNOLOGIES INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

(Unaudited)

| | June 30, 2015 | December 31, 2014 |
|--|------------------|----------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 11,336 | \$ 13,113 |
| Trade receivables, net of allowance for doubtful accounts of \$615 and \$367 at June 30, 2015 and December 31, 2014, respectively | 32,571 | 27,745 |
| Inventories, net | 25,998 | 25,371 |
| Deferred income taxes | 1,388 | 1,888 |
| Prepaid expenses and other assets | 3,277 | 2,667 |
| Total Current Assets | 74,570 | 70,784 |
| Property, plant and equipment, net | 36,173 | 37,041 |
| Deferred income taxes | 2,515 | 2,723 |
| Intangible assets, net | 31,327 | 32,791 |
| Goodwill | 17,840 | 18,303 |
| Other long term assets | 4,395 | 3,998 |
| Total Assets | \$ 166,820 | \$ 165,640 |
| Liabilities and Stockholders Equity | | |
| Current Liabilities: | | |
| Debt obligations | 9,884 | 7,723 |
| Accounts payable | 16,754 | 15,510 |
| Accrued liabilities | 9,861 | 12,330 |
| Income taxes payable | 785 | 393 |
| Total Current Liabilities | 37,284 | 35,956 |
| Long-term debt | 63,375 | 67,125 |
| Deferred income taxes | 1,129 | 1,299 |
| Deferred compensation arrangements | 2,788 | 2,167 |
| Pension and post-retirement obligations | 3,078 | 3,142 |
| Total Liabilities | 107,654 | 109,689 |
| Commitments and Contingencies | | |
| Stockholders Equity: | | |
| Common stock, no par value, authorized 50,000 shares; 9,291 and 9,213 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively | 26,329 | 25,129 |
| Preferred stock, par value \$1.00 per share, authorized 5,000 shares; no shares issued or outstanding | | |
| Retained earnings | 42,141 | 36,505 |
| Accumulated other comprehensive income (loss) | (9,304) | (5,683) |
| Total Stockholders Equity | 59,166 | 55,951 |
| Total Liabilities and Stockholders Equity | \$ 166,820 | \$ 165,640 |

See accompanying notes to condensed consolidated financial statements.

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ALLIED MOTION TECHNOLOGIES INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands, except per share data)

(Unaudited)

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|-----------|--------------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenues | \$ 60,479 | \$ 62,069 | \$ 120,059 | \$ 122,504 |
| Cost of goods sold | 42,492 | 43,501 | 84,572 | 86,844 |
| Gross margin | 17,987 | 18,568 | 35,487 | 35,660 |
| Operating costs and expenses: | | | | |
| Selling | 2,063 | 2,232 | 4,271 | 4,342 |
| General and administrative | 5,822 | 6,709 | 11,375 | 12,925 |
| Engineering and development | 3,707 | 3,472 | 7,153 | 6,989 |
| Amortization of intangible assets | 660 | 670 | 1,322 | 1,348 |
| Total operating costs and expenses | 12,252 | 13,083 | 24,121 | 25,604 |
| Operating income | 5,735 | 5,485 | 11,366 | 10,056 |
| Other expense (income): | | | | |
| Interest expense | 1,511 | 1,649 | 3,026 | 3,287 |
| Other (expense) income, net | (19) | 53 | (285) | (299) |
| Total other expense, net | 1,492 | 1,702 | 2,741 | 2,988 |
| Income before income taxes | 4,243 | 3,783 | 8,625 | 7,068 |
| Provision for income taxes | (1,118) | (1,090) | (2,524) | (2,227) |
| Net income | \$ 3,125 | \$ 2,693 | \$ 6,101 | \$ 4,841 |
| Basic earnings per share: | | | | |
| Earnings per share | \$ 0.34 | \$ 0.29 | \$ 0.66 | \$ 0.53 |
| Basic weighted average common shares | 9,264 | 9,152 | 9,225 | 9,136 |
| Diluted earnings per share: | | | | |
| Earnings per share | \$ 0.34 | \$ 0.29 | \$ 0.66 | \$ 0.53 |
| Diluted weighted average common shares | 9,264 | 9,152 | 9,225 | 9,136 |
| Net income | \$ 3,125 | \$ 2,693 | \$ 6,101 | \$ 4,841 |
| Foreign currency translation adjustment | 917 | (332) | (3,562) | (325) |
| Change in accumulated income (loss) on derivatives | 41 | (89) | (59) | (98) |
| Comprehensive income | \$ 4,083 | \$ 2,272 | \$ 2,480 | \$ 4,418 |

See accompanying notes to condensed consolidated financial statements.

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ALLIED MOTION TECHNOLOGIES INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | For the six months ended | |
|---|--------------------------|-----------|
| | 2015 | 2014 |
| | June 30, | |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 6,101 | \$ 4,841 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,665 | 3,481 |
| Deferred income taxes | 555 | 575 |
| Stock compensation expense | 926 | 768 |
| Other | 269 | 1,465 |
| Changes in operating assets and liabilities: | | |
| Trade receivables | (5,975) | (4,979) |
| Inventories, net | (1,514) | (1,488) |
| Prepaid expenses and other assets | (666) | 593 |
| Accounts payable | 1,757 | 1,173 |
| Accrued liabilities | (1,519) | (71) |
| Net cash provided by operating activities | 3,599 | 6,358 |
| Cash Flows From Investing Activities: | | |
| Purchase of property and equipment | (2,708) | (1,571) |
| Proceeds related to working capital adjustment on acquisition | | 1,399 |
| Net cash used in investing activities | (2,708) | (172) |
| Cash Flows From Financing Activities: | | |
| Borrowings on lines-of-credit, net | 1,398 | (2,591) |
| Principal payments of long-term debt | (3,000) | (2,500) |
| Dividends paid to stockholders | (465) | (499) |
| Stock transactions under employee benefit stock plans | 223 | 304 |
| Net cash used in financing activities | (1,844) | (5,286) |
| Effect of foreign exchange rate changes on cash | (824) | (83) |
| Net (decrease) increase in cash and cash equivalents | (1,777) | 817 |
| Cash and cash equivalents at beginning of period | 13,113 | 10,171 |
| Cash and cash equivalents at end of period | \$ 11,336 | \$ 10,988 |

See accompanying notes to condensed consolidated financial statements.

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ALLIED MOTION TECHNOLOGIES INC.

UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

1. BASIS OF PREPARATION AND PRESENTATION

Allied Motion Technologies Inc. (Allied Motion or the Company) is engaged in the business of designing, manufacturing and selling motion control solutions, which include integrated system solutions as well as individual motion control products, to a broad spectrum of customers throughout the world primarily for the commercial motor, industrial motion, automotive control, medical, and aerospace and defense markets.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

The assets and liabilities of the Company's foreign subsidiaries are translated into U.S. dollars using end of period exchange rates. Changes in reported amounts of assets and liabilities of foreign subsidiaries that occur as a result of changes in exchange rates between foreign subsidiaries functional currencies and the U.S. dollar are included in foreign currency translation adjustment. Foreign currency translation adjustment is included in accumulated other comprehensive income, a component of stockholders' equity in the accompanying condensed consolidated balance sheets. Revenue and expense transactions use an average rate prevailing during the month of the related transaction. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency of each Technology Unit (TU) are included in the results of operations as incurred.

The condensed consolidated financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission and include all adjustments which are, in the opinion of management, necessary for a fair presentation. Certain information and footnote disclosures normally included in financial statements which are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) have been condensed or omitted pursuant to such rules and regulations. The Company believes that the disclosures herein are adequate to make the information presented not misleading. The financial data for the interim periods may not necessarily be indicative of results to be expected for the year.

The preparation of financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions. Such estimates and assumptions affect the reported amounts of assets and liabilities as well as disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

It is suggested that the accompanying condensed consolidated financial statements be read in conjunction with the Consolidated Financial Statements and related Notes to such statements included in the Annual Report on Form 10-K for the year ended December 31, 2014 that was previously filed by the Company.

Reclassification

Certain items in the prior year's consolidated financial statements and notes to consolidated financial statements have been reclassified to conform to the 2015 presentation.

2. INVENTORIES

Inventories include costs of materials, direct labor and manufacturing overhead, and are stated at the lower of cost (first-in, first-out basis) or market, as follows (in thousands):

| | June 30, 2015 | December 31, 2014 |
|-------------------------|--------------------------|------------------------------|
| Parts and raw materials | \$ 23,220 | \$ 21,573 |
| Work-in-process | 2,953 | 2,924 |
| Finished goods | 3,369 | 4,403 |
| | 29,542 | 28,900 |
| Less reserves | (3,544) | (3,529) |
| Inventories, net | \$ 25,998 | \$ 25,371 |

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ALLIED MOTION TECHNOLOGIES INC.

UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

3. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is classified as follows (in thousands):

| | June 30, 2015 | | December 31, 2014 |
|--------------------------------------|------------------|----|----------------------|
| Land | \$ 974 | \$ | 996 |
| Building and improvements | 9,487 | | 9,324 |
| Machinery, equipment, tools and dies | 37,275 | | 37,426 |
| Furniture, fixtures and other | 7,913 | | 6,778 |
| | 55,649 | | 54,524 |
| Less accumulated depreciation | (19,476) | | (17,483) |
| Property, plant and equipment, net | \$ 36,173 | \$ | 37,041 |

Depreciation expense was approximately \$1,198 and \$1,123 for the quarters ended June 30, 2015 and 2014, respectively. For the six months ended June 30, 2015 and 2014, depreciation expense was \$2,343 and \$2,133, respectively.

4. GOODWILL

The change in the carrying amount of goodwill for the quarter ended June 30, 2015 and year ended December 31, 2014 is as follows (in thousands):

| | June 30, 2015 | | December 31, 2014 |
|--|------------------|----|----------------------|
| Beginning balance | \$ 18,303 | \$ | 20,233 |
| Acquisition adjustments | | | (1,223) |
| Effect of foreign currency translation | (463) | | (707) |
| Ending balance | \$ 17,840 | \$ | 18,303 |

5. INTANGIBLE ASSETS

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Intangible assets on the Company's condensed consolidated balance sheets consist of the following (in thousands):

| | Life | Gross Amount | June 30, 2015 Accumulated amortization | Net Book Value | Gross Amount | December 31, 2014 Accumulated amortization | Net Book Value |
|-------------------------|--------------|------------------|--|-------------------|------------------|--|-------------------|
| Customer lists | 8 - 15 years | \$ 34,184 | \$ (6,742) | \$ 27,442 | \$ 34,379 | \$ (5,801) | \$ 28,578 |
| Trade name | 10 years | 4,775 | (1,601) | 3,174 | 4,775 | (1,409) | 3,366 |
| Design and technologies | 8 - 10 years | 2,224 | (1,532) | 692 | 2,425 | (1,598) | 827 |
| Patents | | 24 | (5) | 19 | 24 | (4) | 20 |
| Total | | \$ 41,207 | \$ (9,880) | \$ 31,327 | \$ 41,603 | \$ (8,812) | \$ 32,791 |

Amortization expense for intangible assets was \$660 and \$670 for the quarters ending June 30, 2015 and 2014, respectively; and \$1,322 and \$1,348 for the six months ended June 30, 2015 and 2014, respectively.

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ALLIED MOTION TECHNOLOGIES INC.

UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

Estimated future intangible asset amortization expense as of June 30, 2015 is as follows (in thousands):

| | Estimated Amortization Expense |
|--------------------------------------|---|
| Remainder of 2015 | \$ 1,323 |
| 2016 | 2,645 |
| 2017 | 2,645 |
| 2018 | 2,645 |
| 2019 | 2,645 |
| Thereafter | 19,424 |
| Total estimated amortization expense | \$ 31,327 |

6. STOCK-BASED COMPENSATION

Stock Incentive Plans

The Company's Stock Incentive Plans provide for the granting of stock awards, including restricted stock, stock options and stock appreciation rights, to employees and non-employees, including directors of the Company.

Restricted Stock

For the six months ended June 30, 2015, 74,714 shares of unvested restricted stock were awarded at a weighted average market value of \$27.59. Of the restricted shares granted, 41,792 shares have performance based vesting conditions. The value of the shares is amortized to compensation expense over the related service period, which is normally three years, or over the estimated performance period. Shares of unvested restricted stock are forfeited if a recipient leaves the Company before the vesting date. Shares that are forfeited become available for future awards.

The following is a summary of restricted stock activity for the six months ended June 30, 2015:

| | Number of shares |
|------------------------------------|------------------|
| Outstanding at beginning of period | 487,678 |
| Awarded | 74,714 |
| Vested | (140,465) |
| Forfeited | (6,700) |
| Outstanding at end of period | 415,227 |

Compensation expense, net of forfeitures of \$502 and \$388 was recorded for the three months ended June 30, 2015 and 2014, respectively. For the six months ended June 30, 2015 and 2014, stock compensation expense, net of forfeitures, of \$926 and \$768 was recorded, respectively.

7. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

| | June 30, 2015 | December 31, 2014 |
|----------------------------------|------------------|----------------------|
| Compensation and fringe benefits | \$ 6,676 | \$ 9,696 |
| Warranty reserve | 761 | 786 |
| Other accrued expenses | 2,424 | 1,848 |
| | \$ 9,861 | \$ 12,330 |

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ALLIED MOTION TECHNOLOGIES INC.

UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

8. DEBT OBLIGATIONS

Debt obligations consisted of the following (in thousands):

| | | June 30, 2015 | | December 31, 2014 |
|---|----|--------------------------|----|------------------------------|
| Current Borrowings | | | | |
| Revolving Credit Facility | \$ | 1,000 | \$ | |
| China Credit Facility (6.4% at June 30, 2015) | | 1,759 | | 1,348 |
| Term Loan, current portion, (2.2% at June 30, 2015) (1) | | 7,125 | | 6,375 |
| Current borrowings | \$ | 9,884 | \$ | 7,723 |
| Long-term Debt | | | | |
| Term Loan, noncurrent (2.2% at June 30, 2015) (1) | \$ | 33,375 | \$ | 37,125 |
| Subordinated Notes (14.5%, 13% Cash, 1.5% PIK) | | 30,000 | | 30,000 |
| Long-term debt | \$ | 63,375 | \$ | 67,125 |

(1) The effective rate of the Term Loan including the impact of the related hedges is 2.65%.

Credit Agreement

The Company's Credit Agreement provides for a \$15,000 five-year revolving credit facility and a \$50,000 five-year term loan (collectively the Senior Credit Facilities).

Borrowings under the Senior Credit Facilities are subject to terms defined in the Credit Agreement. Borrowings bear interest at either the Base Rate plus a margin of 0.25% to 2.00% (currently 1.50%) or the Eurocurrency Rate plus a margin of 1.25% to 3.00% (currently 2.0%), in each case depending on the Company's ratio of total funded indebtedness to Consolidated EBITDA (the Total Leverage Ratio).

Principal installments are payable on the Term Loan in varying percentages quarterly through September 30, 2018 with a balloon payment at maturity. The Senior Credit Facilities are secured by substantially all of the Company's assets. The average outstanding borrowings for 2015 for the Senior Credit Facilities were \$42,600. At June 30, 2015, there was approximately \$14,000 available under the Senior Credit Facilities.

The Credit Agreement contains certain financial covenants related to maximum leverage and minimum fixed charge coverage. The Credit Agreement also includes other covenants and restrictions, including limits on the amount of certain types of capital expenditures. The Company was in compliance with all covenants at June 30, 2015.

Senior Subordinated Notes

Under the Company's Note Agreement, the Company sold \$30,000 of 14.50% Senior Subordinated Notes due October 18, 2019 (the Notes) to Prudential Capital Partners IV, L.P. and its affiliates in a private placement. The interest rate on the Notes is 14.50% with 13.00% payable in cash and 1.50% payable in-kind, quarterly in arrears and the outstanding principal amount of the Notes, together with any accrued and unpaid interest is due on October 18, 2019. The Company may prepay the Notes at any time after October 18, 2016, in whole or in part, at 100% of the principal amount. The Notes are unsecured obligations of the Company and are fully and unconditionally guaranteed by certain of the Company's subsidiaries.

Other

The Company has a China Credit Facility that provides credit of approximately \$1,970 (Chinese Renminbi (RMB) 12,000). The China Facility is used for working capital and capital equipment needs at the Company's China operations, and will mature in November, 2017. The average balance for 2015 was \$1,660 (RMB 10,100). At June 30, 2015, there was approximately \$210 (RMB 1,290) available under the facility.

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UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

Maturities of long-term debt as of June 30, 2015 are as follows (in thousands):

| | Total |
|-------------------|--------------|
| Remainder of 2015 | \$ 6,134 |
| 2016 | 8,219 |
| 2017 | 10,374 |
| 2018 | 18,532 |
| 2019 | 30,000 |
| Total | \$ 73,259 |

9. FAIR VALUE

Authoritative guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date.

The guidance establishes a framework for measuring fair value which utilizes observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. Preference is given to observable inputs. These two types of inputs create the following three-level fair value hierarchy:

- Level 1: Quoted prices for identical assets or liabilities in active markets.
- Level 2: Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and model-derived valuations whose inputs or significant value drivers are observable.
- Level 3: Significant inputs to the valuation model that are unobservable.

The Company's financial assets and liabilities include cash and cash equivalents, accounts receivable, debt obligations, accounts payable, and accrued liabilities. The carrying amounts reported in the condensed consolidated balance sheets for these assets approximate fair value because of the immediate or short-term maturities of these financial instruments.

The following table presents the Company's financial assets that are accounted for at fair value on a recurring basis as of June 30, 2015 and December 31, 2014, respectively, by level within the fair value hierarchy (in thousands):

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| | June 30, 2015 | | | | | | |
|--|---------------------|--------------|--------------|---------------------|--------------|--------------|--|
| | Level 1 | Level 2 | Level 3 | | | | |
| Assets | | | 42 | 0.26% | | | |
| Money Market | 158,284 | 226 | 0.57% | 162,172 | 507 | 1.24% | |
| CDAR s | 52,953 | 124 | 0.93% | 144,247 | 523 | 1.44% | |
| Certificates of Deposit < \$100,000 | 178,118 | 336 | 0.75% | 121,876 | 408 | 1.33% | |
| Certificates of Deposit ³ \$100,000 | 196,438 | 320 | 0.65% | 199,204 | 485 | 0.97% | |
| Brokered Deposits | 7,609 | 37 | 1.93% | 30,663 | 138 | 1.79% | |
| Total Interest Bearing Deposits | 851,137 | 1,496 | 0.70% | 837,685 | 2,229 | 1.06% | |
| Borrowed Funds: | | | | | | | |
| Federal Funds Purchased | 9 | | 0.00% | 473 | 1 | 0.84% | |
| Repurchase Agreements | | | 0.00% | 10,802 | 5 | 0.18% | |
| Short Term Borrowings | 13,281 | 49 | 1.46% | 27,067 | 92 | 1.35% | |
| Long Term Borrowings | 15,000 | 143 | 3.78% | 20,000 | 186 | 3.69% | |
| TRUPS | 30,928 | 198 | 2.54% | 30,928 | 190 | 2.44% | |
| Total Borrowed Funds | 59,218 | 390 | 2.61% | 89,270 | 474 | 2.11% | |
| Total Interest Bearing Liabilities | 910,355 | 1,886 | 0.82% | 926,955 | 2,703 | 1.16% | |
| Demand Deposits | 249,563 | | | 233,791 | | | |
| Other Liabilities | 22,555 | | | 14,664 | | | |
| Shareholders Equity | 141,384 | | | 118,658 | | | |
| Total Liabilities and Shareholders Equity | \$ 1,323,857 | | | \$ 1,294,068 | | | |
| Interest | | | | | | | |
| Income/Interest Earning Assets | | | 5.49% | | | 5.86% | |
| Interest Expense/Interest Earning Assets | | | 0.64% | | | 0.91% | |
| Net Interest Income and Margin ^(d) | | \$ 14,022 | 4.85% | | \$ 14,321 | 4.95% | |

- (a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
- (b) Yields and net interest margin have been computed on a tax equivalent basis using an effective tax rate of 35%.
- (c) Net loan costs have been included in the calculation of interest income. Net loan costs were approximately \$143 thousand and \$75 thousand for the quarters ended September 30, 2010 and 2009.
Loans are gross of the allowance for possible loan losses.
- (d) Represents net interest income as a percentage of average interest-earning assets.
- (e) Non-accrual loans have been included in total loans for purposes of total earning assets.
- (f) Annualized

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| | Nine Months Ended September 30, 2010 ^(a) ^(b) ^(f) | | | Nine Months Ended September 30, 2009 ^(a) ^(b) ^(f) | | |
|--|--|--------------------|-----------------------|--|--------------------|-----------------------|
| | Average Balance | Income/ Expense | Average Rate/Yield | Average Balance | Income/ Expense | Average Rate/Yield |
| (dollars in thousands, except per share data) | | | | | | |
| Assets | | | | | | |
| <u>Investments:</u> | | | | | | |
| Federal funds sold/Due from time | \$ 14,607 | \$ 30 | 0.27% | \$ 10,482 | \$ 79 | 1.01% |
| Taxable | 235,065 | 6,282 | 3.57% | 180,714 | 6,124 | 4.53% |
| Non-taxable | 67,863 | 2,012 | 6.10% | 60,771 | 1,846 | 6.25% |
| Equity | 1,510 | | 0.00% | 1,990 | 73 | 4.90% |
| Total Investments | 319,045 | 8,324 | 3.94% | 253,957 | 8,122 | 4.80% |
| <u>Loans and Leases:</u> ^(c) ^(e) | | | | | | |
| Agricultural | 9,828 | 376 | 5.12% | 12,781 | 540 | 5.65% |
| Commercial | 116,618 | 5,216 | 5.98% | 142,427 | 6,252 | 5.87% |
| Real Estate | 619,894 | 30,732 | 6.63% | 653,818 | 32,957 | 6.74% |
| Consumer | 51,710 | 3,342 | 8.64% | 63,031 | 4,034 | 8.56% |
| Direct Financing Leases | 11,360 | 481 | 5.66% | 15,605 | 688 | 5.89% |
| Other | 53,181 | | 0.00% | 47,027 | | 0.00% |
| Total Loans and Leases | 862,591 | 40,147 | 6.22% | 934,689 | 44,471 | 6.36% |
| Total Interest Earning Assets ^(e) | 1,181,636 | 48,471 | 5.61% | 1,188,646 | 52,593 | 6.03% |
| Other Earning Assets | 9,137 | | | 9,361 | | |
| Non-Earning Assets | 132,487 | | | 109,113 | | |
| Total Assets | \$ 1,323,260 | | | \$ 1,307,120 | | |
| Liabilities and Shareholders Equity | | | | | | |
| <u>Interest Bearing Deposits:</u> | | | | | | |
| NOW | \$ 176,095 | \$ 1,320 | 1.00% | \$ 109,170 | \$ 311 | 0.38% |
| Savings Accounts | 69,039 | 124 | 0.24% | 60,709 | 129 | 0.28% |
| Money Market | 166,879 | 723 | 0.58% | 153,799 | 1,594 | 1.39% |
| CDAR s | 81,732 | 555 | 0.91% | 132,015 | 1,769 | 1.79% |
| Certificates of Deposit < \$100,000 | 155,927 | 952 | 0.82% | 119,487 | 1,506 | 1.69% |
| Certificates of Deposit ³ \$100,000 | 194,660 | 941 | 0.65% | 206,645 | 1,776 | 1.15% |
| Brokered Deposits | 14,553 | 210 | 1.93% | 73,304 | 1,104 | 2.01% |
| Total Interest Bearing Deposits | 858,885 | 4,825 | 0.75% | 855,129 | 8,189 | 1.28% |
| <u>Borrowed Funds:</u> | | | | | | |
| Federal Funds Purchased | 4 | | 0.00% | 387 | 1 | 0.35% |
| Repurchase Agreements | | | 0.00% | 19,917 | 35 | 0.23% |
| Short Term Borrowings | 16,465 | 141 | 1.14% | 20,377 | 301 | 1.97% |
| Long Term Borrowings | 16,392 | 461 | 3.76% | 22,674 | 611 | 3.60% |
| TRUPS | 30,928 | 553 | 2.39% | 30,928 | 734 | 3.17% |
| Total Borrowed Funds | 63,789 | 1,155 | 2.42% | 94,283 | 1,682 | 2.39% |
| Total Interest Bearing Liabilities | 922,674 | 5,980 | 0.87% | 949,412 | 9,871 | 1.39% |
| Demand Deposits | 245,378 | | | 229,793 | | |

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| | | | | |
|--|---------------------|--------------|---------------------|--------------|
| Other Liabilities | 16,524 | | 15,015 | |
| Shareholders' Equity | 138,684 | | 112,900 | |
| Total Liabilities and Shareholders' Equity | \$ 1,323,260 | | \$ 1,307,120 | |
| Interest Income/Interest Earning Assets | | 5.61% | | 6.03% |
| Interest Expense/Interest Earning Assets | | 0.68% | | 1.11% |
| Net Interest Income and Margin ^(d) | \$ 42,491 | 4.93% | \$ 42,722 | 4.92% |

- (a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
- (b) Yields and net interest margin have been computed on a tax equivalent basis using an effective tax rate of 35%.
- (c) Net loan costs have been included in the calculation of interest income. Net loan costs were approximately \$331 thousand and \$31 thousand for the nine months ended September 30, 2010 and 2009.
Loans are gross of the allowance for possible loan losses.
- (d) Represents net interest income as a percentage of average interest-earning assets.
- (e) Non-accrual loans have been included in total loans for purposes of total earning assets.
- (f) Annualized

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

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balances. Variances attributable to both rate and volume changes are calculated by multiplying the change in rate by the change in average balance, and have been allocated to the rate variance.

Volume & Rate Variances

| (dollars in thousands) | Quarter Ended | | | Nine Months Ended | | |
|---|---|--------------|----------------|---|----------------|----------------|
| | September 30, 2010 over 2009 Increase(decrease) due to Volume | Rate | Net | September 30, 2010 over 2009 Increase(decrease) due to Volume | Rate | Net |
| Assets: | | | | | | |
| <u>Investments:</u> | | | | | | |
| Federal funds sold / Due from time | 10 | (4) | 6 | 31 | (80) | (49) |
| Taxable | 703 | (610) | 93 | 1,842 | (1,684) | 158 |
| Non-taxable ⁽¹⁾ | 89 | (31) | 58 | 215 | (49) | 166 |
| Equity | (5) | (6) | (11) | (18) | (55) | (73) |
| Total Investments | 797 | (651) | 146 | 2,070 | (1,868) | 202 |
| <u>Loans and Leases:</u> | | | | | | |
| Agricultural | (40) | (6) | (46) | (125) | (39) | (164) |
| Commercial | (439) | 24 | (415) | (1,133) | 97 | (1,036) |
| Real Estate | (488) | (9) | (497) | (1,710) | (515) | (2,225) |
| Consumer | (242) | 3 | (239) | (725) | 33 | (692) |
| Direct Financing Leases | (55) | (10) | (65) | (187) | (20) | (207) |
| Other | | | | | | |
| Total Loans and Leases | (1,264) | 2 | (1,262) | (3,880) | (444) | (4,324) |
| Total Interest Earning Assets | (467) | (649) | (1,116) | (1,810) | (2,312) | (4,122) |
| Liabilities | | | | | | |
| <u>Interest Bearing Deposits:</u> | | | | | | |
| NOW | 75 | 205 | 280 | 191 | 818 | 1,009 |
| Savings Accounts | 6 | (1) | 5 | 18 | (23) | (5) |
| Money Market | (12) | (269) | (281) | 136 | (1,007) | (871) |
| CDAR s | (331) | (68) | (399) | (674) | (540) | (1,214) |
| Certificates of Deposit < \$100,000 | 188 | (260) | (72) | 459 | (1,013) | (554) |
| Certificates of Deposit ≥ \$100,000 | (7) | (158) | (165) | (103) | (732) | (835) |
| Brokered Deposits | (104) | 3 | (101) | (885) | (9) | (894) |
| Total Interest Bearing Deposits | (185) | (548) | (733) | (858) | (2,506) | (3,364) |
| <u>Borrowed Funds:</u> | | | | | | |
| Federal Funds Purchased | (1) | | (1) | (1) | | (1) |
| Repurchase Agreements | (5) | | (5) | (35) | | (35) |
| Short Term Borrowings | (47) | 4 | (43) | (58) | (102) | (160) |
| Long Term Borrowings | (47) | 4 | (43) | (169) | 19 | (150) |
| TRUPS | | 8 | 8 | | (181) | (181) |
| Total Borrowed Funds | (100) | 16 | (84) | (263) | (264) | (527) |
| Total Interest Bearing Liabilities | (285) | (532) | (817) | (1,121) | (2,770) | (3,891) |

| | | | | | | |
|-----------------------------------|-------|-------|-------|-------|-----|-------|
| Net Interest Margin/Income | (182) | (117) | (299) | (689) | 458 | (231) |
|-----------------------------------|-------|-------|-------|-------|-----|-------|

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

As shown above, the volume variance for the third quarter of 2010 relative to the third quarter of 2009 was negative \$182,000, despite the fact that average interest-earning assets were about \$2 million higher in the third quarter of 2010. The negative volume variance was primarily the result of balance movement within assets, where we experienced an \$80 million drop in average loans due to declining balances of relatively high-yielding real estate, commercial and consumer loans. The average balance of investments increased \$81 million, but investment yields are significantly lower than our average loan yields. Furthermore, the average balance of non-earning assets increased by \$29 million, due mainly to an increase of \$13 million in the average balance of OREO, a \$5 million increase in our prepaid FDIC assessment, and a higher deferred tax asset balance. The unfavorable shift in average asset balances was partially offset by favorable changes on the liability side, where we experienced movement out of CDARS, brokered deposits, and wholesale borrowings into lower-cost core deposits. An increase in average equity, resulting from our private placement in August 2009 and the addition of net income, also helped reduce our reliance on interest-bearing liabilities and thus helped limit the magnitude of the negative volume variance.

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The rate variance was also negative for the quarter, contributing \$117,000 to the drop in net interest income. There hasn't been a significant change in market interest rates during the past year, but our weighted average yield on interest-earning assets was 37 basis points lower due to the addition of investment securities in a relatively low-rate environment. The weighted average cost of interest-bearing liabilities was also 34 basis points lower, due primarily to an improving deposit mix, as well as easing of competitive pressures on money market and time deposit rates that was partially offset by an increase in the cost of NOW deposits resulting from growth in our relatively high-rate Reward Checking product. The negative rate variance is exacerbated by our sizeable net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. Our average net interest position for the third quarter of 2009, which is the base period for the rate variance calculation, was \$249 million, meaning that the yield decrease for interest-earning assets was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income. Net interest reversals, totaling \$260,000 for the third quarter of 2010 and \$355,000 for the third quarter of 2009, also impacted the rate variance and relative level of net interest income for the comparative quarters.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.85% in the third quarter of 2010, a decline of 10 basis points relative to the third quarter of 2009. The principal negative pressure on our net interest margin for the quarter came from the unfavorable shift in average asset balances. Having a positive impact for the quarterly comparison were increases of \$23 million in average equity and \$16 million in average non-interest bearing demand deposit balances, which reduced our reliance on interest-bearing liabilities, and a \$95,000 reduction in net interest reversals.

For the first nine months of 2010 relative to the first nine months of 2009, the negative variance in net interest income attributable purely to volume changes was \$689,000, while there was a favorable rate variance of \$458,000. The negative volume variance was due in part to the fact that average interest-earning assets declined by \$7 million, or 1%, for the comparative periods. Furthermore, there was movement out of average performing loan balances into lower-yielding investments, OREO, and nonperforming loans, although that unfavorable shift was partially offset by relatively strong growth in the average balance of low-cost customer deposits and equity.

Many of the same factors discussed for the quarterly rate variance are applicable with regard to the rate variance for the year-to-date comparison, but for the comparative year-to-date periods the weighted average cost of interest-bearing liabilities fell by 10 basis points more than did our yield on average interest-earning assets. For the first nine months of 2010 relative to the first nine months of 2009, the weighted average cost of interest-bearing liabilities fell by 52 basis points while the weighted average yield on earning assets was only 42 basis points lower, tilting the balance in favor of a positive rate variance.

The Company's net interest margin for the first nine months of 2010 was 4.93%, an improvement of 1 basis point relative to the net interest margin of 4.92% in the first nine months of 2009. For the first nine months, the relatively large drop in our cost of interest-bearing liabilities, combined with increases of \$26 million in average equity and \$16 million in average non-interest bearing demand deposits, helped to offset negative pressures. Those negative forces include a shift into lower yielding investment securities, a \$17 million increase in average OREO, a \$6 million increase in our prepaid FDIC assessment, and a higher level of deferred tax assets. Net interest reversals were also modestly lower in the first nine months of 2010, falling to \$665,000 relative to \$711,000 in the first nine months of 2009.

PROVISION FOR LOAN AND LEASE LOSSES

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses through periodic charges to earnings, which are reflected in the income statement as the provision for loan losses. Those charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans, as well as probable incurred loan losses in the remaining loan portfolio.

The Company's provision for loan losses was reduced by \$4.1 million, or 39%, in the third quarter of 2010 relative to the third quarter of 2009, and by \$4.7 million, or 26%, in the first nine months of 2010 relative to the first nine months of 2009. The loan loss provision typically includes reserve replenishment subsequent to loan charge-offs, as well as the enhancement of general reserves for performing loans and specific reserves for impaired loans as needed pursuant to a detailed analysis of the adequacy our allowance for

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loan and lease losses. For 2010, the provision has primarily been used to establish specific reserves for loan and lease balances that have been transferred to non-accrual status. Balances transferred to non-accrual status totaled \$23 million for the third quarter, and \$47 million for the first nine months of 2010. Total specific reserves for nonperforming loans actually declined by \$4.3 million at September 30, 2010 relative to December 31, 2009, however, because many of the balances charged-off in 2010 were against specific reserves which had been established in prior periods. The charge-off against specific reserves reduced or eliminated the need for reserves on certain nonperforming loans, thus those charge-offs did not necessarily create the need for reserve replenishment. Net loans charged off in the third quarter of 2010 totaled \$11.4 million relative to \$3.5 million in the third quarter of 2009, while net charge-offs were \$17.2 million for the first nine months of 2010 relative to \$9.7 million in the first nine months of 2009. Our 2010 loan loss provision was also used to enhance general reserves for losses inherent in performing loans. Those reserves increased by \$395,000 despite a drop of \$57 million in gross loan balances, due to higher historical loss factors and qualitative factor adjustments that raised our estimate of probable losses in the performing loan portfolio. The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed below in Allowance for Loan and Lease Losses.

Table of Contents**NON-INTEREST REVENUE AND OPERATING EXPENSE**

The following table provides details on the Company's non-interest income and operating expense for the third quarter and first nine months of 2010 relative to the third quarter and first nine months of 2009:

Non Interest Income/Expense

| (dollars in thousands, unaudited) | For the Quarter Ended September 30, | | | | For the Nine-Month Period Ended September 30, | | | |
|--|--|----------------|------------------|----------------|--|----------------|------------------|----------------|
| | 2010 | % of Total | 2009 | % of Total | 2010 | % of Total | 2009 | % of Total |
| OTHER OPERATING INCOME: | | | | | | | | |
| Service charges on deposit accounts | \$ 2,959 | 41.95% | \$ 3,030 | 54.51% | \$ 8,549 | 57.36% | \$ 8,582 | 64.83% |
| Other service charges, commissions & fees | \$ 1,001 | 14.19% | 826 | 14.86% | 3,155 | 21.17% | 2,200 | 16.61% |
| Gains on sales of loans | \$ 23 | 0.33% | 42 | 0.75% | 60 | 0.40% | 58 | 0.44% |
| Gains on securities | \$ 2,639 | 37.43% | 1,005 | 18.08% | 2,639 | 17.72% | 1,099 | 8.30% |
| Loan servicing income | \$ 6 | 0.09% | 11 | 0.20% | 16 | 0.11% | 25 | 0.19% |
| Bank owned life insurance | \$ 484 | 6.86% | 631 | 11.35% | 908 | 6.09% | 1,211 | 9.16% |
| Other | \$ (59) | -0.85% | 13 | 0.25% | (424) | -2.85% | 61 | 0.47% |
| Total non-interest income | 7,053 | 100.00% | 5,558 | 100.00% | 14,903 | 100.00% | 13,236 | 100.00% |
| As a % of average interest-earning assets ⁽²⁾ | | 2.38% | | 1.88% | | 1.69% | | 1.49% |
| OTHER OPERATING EXPENSES: | | | | | | | | |
| Salaries and Employee Benefits | 4,582 | 31.39% | 3,543 | 33.00% | 15,511 | 40.48% | 14,033 | 42.60% |
| Occupancy costs | | | | | | | | |
| Furniture & equipment | 545 | 3.73% | 662 | 6.16% | 1,850 | 4.83% | 1,984 | 6.02% |
| Premises | 1,229 | 8.42% | 1,130 | 10.52% | 3,482 | 9.09% | 3,164 | 9.61% |
| Advertising and marketing costs | 537 | 3.68% | 506 | 4.71% | 1,615 | 4.21% | 1,458 | 4.43% |
| Data processing costs | 476 | 3.26% | 356 | 3.31% | 1,305 | 3.41% | 1,020 | 3.10% |
| Deposit services costs | 681 | 4.67% | 543 | 5.06% | 2,076 | 5.42% | 1,590 | 4.83% |
| Loan services costs | | | | | | | | |
| Loan processing | 131 | 0.90% | 285 | 2.65% | 547 | 1.43% | 680 | 2.06% |
| Foreclosed assets | 4,116 | 28.20% | 889 | 8.28% | 5,365 | 14.01% | 1,516 | 4.60% |
| Credit card | | 0.00% | | 0.00% | | 0.00% | | 0.00% |
| Other operating costs | | | | | | | | |
| Telephone & data communications | 305 | 2.09% | 243 | 2.26% | 871 | 2.27% | 853 | 2.59% |
| Postage & mail | 134 | 0.92% | 127 | 1.18% | 418 | 1.09% | 377 | 1.14% |
| Other | 272 | 1.86% | 257 | 2.39% | 763 | 1.99% | 785 | 2.38% |
| Professional services costs | | | | | | | | |
| Legal & accounting | 258 | 1.77% | 452 | 4.21% | 932 | 2.43% | 1,174 | 3.56% |
| Other professional service | 1,073 | 7.35% | 1,460 | 13.59% | 2,678 | 6.99% | 3,478 | 10.57% |
| Stationery & supply costs | 166 | 1.14% | 174 | 1.62% | 538 | 1.40% | 498 | 1.51% |
| Sundry & tellers | 90 | 0.62% | 114 | 1.06% | 365 | 0.95% | 331 | 1.00% |
| Total non-interest Expense | \$ 14,595 | 100.00% | \$ 10,741 | 100.00% | \$ 38,316 | 100.00% | \$ 32,941 | 100.00% |
| As a % of average interest-earning assets ⁽²⁾ | | 4.92% | | 3.62% | | 4.34% | | 3.71% |
| Efficiency Ratio ⁽¹⁾ | 76.10% | | 54.81% | | 67.35% | | 58.21% | |

⁽¹⁾ Tax Equivalent

⁽²⁾ Annualized

The Company's results reflect increases of \$1.5 million, or 27%, in total non-interest income for the third quarter of 2010 relative to the third quarter of 2009, and \$1.7 million, or 13%, for the year-to-date comparison. The increases for both the quarter and the first nine months were due principally to \$2.6 million in gains on investment securities in the third quarter of 2010 relative to gains of \$1.0 million in the third quarter of 2009. Other significant factors include lower income from BOLI, higher losses on the disposition of OREO (which are netted against

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non-interest income), lower costs associated with low-income housing tax credit investments (also netted against income), and increases in debit card interchange fees. The variance for the comparative year-to-date periods would have been greater if not for \$112,000 in non-recurring losses on the termination of operating leases in the first and second quarters of 2010. Total other operating income was an annualized 2.38% of average interest-earning assets in the third quarter of 2010 relative to 1.88% in the third quarter of 2009, and was an annualized 1.69% of average earning assets for the first nine months of 2010 relative to 1.49% for the first nine months of 2009.

Service charge income on deposits declined by \$71,000, or 2%, in the third quarter of 2010 relative to the third quarter of 2009, and reflects a small drop of \$33,000, or less than 1%, for the year-to-date period. These changes might typically be expected to parallel changes in transaction accounts, but the number of transaction accounts (NOW accounts and non-interest bearing DDA s) increased

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by 7% during the first nine months of 2010 and the dollar volume of those accounts increased by 11% for the same period. Service charges have dropped as a percentage of average transaction account balances due to lower overdraft activity, and it is our assumption that consumers have become increasingly cautious in managing their account balances in what has been a difficult economic environment. The level of service charges per account could drop even further due to new consumer legislation requiring customer opt-in for point-of-sale overdrafts, which became fully effective in mid-August 2010, although our experience to date is that the vast majority of our customers who regularly utilize this service are electing to opt in.

Other service charges, commissions, and fees increased by \$175,000, or 21%, for the quarter, due mainly to an increase of \$131,000 in debit card point-of-sale interchange fees and decline of a \$41,000 in pass-through operating costs associated with our investment in low-income housing tax credit funds. Debit card interchange fees are higher in 2010 due to an increase in the number of active cards outstanding and increased per-card usage, and we have adjusted expense accruals for partnership losses on our tax credit investments in 2010 subsequent to the receipt of updated partnership financial statements. For the first nine months, other service charges, commissions, and fees rose by \$955,000, or 43%, with \$586,000 of that increase resulting from a drop in low-income housing tax credit fund costs and \$346,000 due to higher debit card interchange fees.

Loan sale and servicing income remained at minimal levels in 2010 and 2009. However, as noted above, we realized \$2.6 million in gains on securities in the third quarter and first nine months of 2010, relative to \$1.0 million and \$1.1 million in gains for the third quarter and first nine months of 2009, respectively. The investment gains in 2010 were taken pursuant to a portfolio restructuring in the third quarter that involved the sale of \$66 million in mortgage-backed securities, with the proceeds reinvested in agency-issued mortgage-backed securities that have a slightly longer duration and slightly lower yield. Management estimates that as a result of the sale the overall tax-equivalent yield of the portfolio declined by 31 basis points, while the effective duration increased from 1.68 to 1.83. Furthermore, by selling bonds that had declined to relatively small balances due to prepayments, and reinvesting in securities with larger balances, the structure of the portfolio was improved and lends itself to more efficient management.

Bank-owned life insurance income declined by \$147,000, or 23%, in the third quarter of 2010 relative to the third quarter of 2009, and dropped by \$303,000, or 25%, for the first nine months of 2010 compared to the first nine months of 2009. To understand the reason for fluctuations in BOLI income, one needs to distinguish between the two basic types of BOLI owned by the Company: general account, and separate account. At September 30, 2010, the Company had \$28.6 million invested in single-premium general account BOLI. Income from our general account BOLI is used to fund expenses associated with executive salary continuation plans and director retirement plans, and is typically fairly consistent with interest credit rates that do not change frequently. The exchange of select general account policies in the third quarter of 2009 generated a one-time gain of approximately \$72,000, however, which contributed to the overall decline in BOLI income in 2010 relative to 2009. In addition to general account BOLI, the Company had \$2.4 million invested in separate account BOLI at September 30, 2010, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses. Also impacting the drop in BOLI income in 2010 is the fact that net gains on separate account BOLI were \$71,000 lower for the comparative quarters, and \$242,000 lower for the comparative year-to-date periods. Gains and losses on separate account BOLI are related to participant gains and losses on deferred compensation balances. Participant gains are accounted for as expense accruals which, combined with their associated tax effect, effectively offset income on separate account BOLI, while participant losses result in expense accrual reversals that also effectively offset losses on separate account BOLI.

The Other category under non-interest income includes gains and losses on the disposition of real properties and other assets, and rental income generated by the Company's alliance with Investment Centers of America (ICA). Other non-interest income was down by \$72,000 in the third quarter of 2010 in comparison to the third quarter of 2009, and declined by \$485,000 in the first nine months of 2010 relative to the first nine months of 2009, due in large part to losses from the sale of OREO. Net losses on the disposition of OREO totaled \$109,000 and \$446,000 in the third quarter and first nine months of 2010, respectively, relative to \$51,000 and \$89,000 in the third quarter and first nine months of 2009. The decline in other non-interest income for the first nine months also includes \$112,000 in losses incurred upon the disposition of equipment that was acquired subsequent to the termination of operating leases in 2010, as noted above.

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Total operating expense (non-interest expense) was \$14.6 million for the quarter ended September 30, 2010, an increase of \$3.9 million, or 36%, relative to total operating expense for the same period in 2009. The increase is primarily due to a \$3.0 million increase in OREO write-downs and a \$1.0 million increase in salaries and employee benefits. Non-interest expense increased to an annualized 4.92% of average interest-earning assets for the third quarter of 2010 from 3.62% in the third quarter of 2009. For the comparative year-to-date periods, non-interest expense increased by \$5.4 million, or 16%, due in large part to a \$3.3 million increase in OREO write-downs, higher personnel costs, an increase in foreclosed asset expense, and higher deposit costs, partially offset by lower FDIC costs. Non-interest expenses increased to an annualized 4.34% of average earning assets for the first nine months of 2010 from 3.71% in the first nine months of 2009.

The largest component of non-interest expense, salaries and employee benefits, increased by \$1.0 million, or 29%, for the comparative quarters, and by \$1.5 million, or 11%, for the first nine months of 2010 relative to the first nine months of 2009. The increase in salaries and benefits for the quarter can be attributed in large part to a lower reversal of incentive compensation accruals in 2010 than in 2009. Due to updated expectations in both years with regard to the level of net income relative to internal targets, \$700,000 was reversed out of accrued salaries and benefits in the third quarter of 2010 while \$1.6 million was reversed in the third quarter of 2009, and the \$930,000 difference in reversals contributed to the increase in total compensation expense for the comparative quarters. Also contributing to the overall increase in salaries and benefits was a \$92,000 decline in salaries relating to successful loan originations in 2010 compared to 2009. Since this portion of salaries is deferred and amortized against interest income, it has the effect of reducing current-period expense. This figure has dropped due simply to lower loan origination activity. Having a small favorable impact on the change in salaries and benefits was the fact that participant gains on deferred compensation plans were lower in the third

quarter of 2010 than in the third quarter of 2009, which caused deferred compensation expense accruals to fall by \$27,000, although as noted above in our discussion of non-interest income, deferred compensation expense accruals are offset by non-taxable gains on BOLI. The year-to-date increase is primarily the result of the difference in incentive compensation accrual reversals in the respective third quarters, but also includes severance costs associated with selective staff reductions in 2010. There was also a \$150,000 drop in salaries relating to successful loan originations which contributed to the year-to-date increase in salaries expense, while deferred compensation expense declined by \$89,000 for the comparative year-to-date periods. Also impacting compensation costs for both the quarterly and year-to-date comparisons were normal annual salary adjustments, the addition of staff for branches opened in October 2009 and March 2010, and strategic staff additions to help address credit issues and position the Company for future growth opportunities. Mainly because of the disproportionate increase in OREO write-downs, salaries and benefits dropped to 31.39% of total non-interest expense for the third quarter of 2010 from 33.00% in the third quarter of 2009, and to 40.48% for the first nine months of 2010 from 42.60% in the first nine months of 2009.

Occupancy expense dropped by \$18,000, or 1%, for the third quarter, because of declining depreciation expense and lower maintenance and repair costs for furniture and equipment. However, occupancy expense was up by \$184,000, or 4%, for the first nine months, due primarily to costs associated with our newer branches and annual rent increases. Marketing costs increased by \$31,000, or 6%, for the quarter, and by \$157,000, or 11%, for the year-to-date period, due to the expansion of direct mail pieces to cover areas surrounding our newer branches and customer education efforts associated with the new legislation on overdrafts. Data processing costs were up as well, rising by \$120,000, or 34%, for the quarter, and by \$285,000, or 28%, for the year-to-date period, due to higher internet banking costs and annual increases in maintenance costs associated with our core processing software and related components. Deposit services costs also experienced a fairly significant increase, rising by \$138,000, or 25%, for the third quarter, and by \$486,000, or 31%, for the first nine months, due mainly to higher costs associated with our online checking product. Included in the deposit cost increases, and related to the increase in point-of-sale interchange fees noted above, are increases in debit card processing costs of \$37,000 and \$122,000 for the third quarter and the first nine months, respectively.

Loan services costs experienced the largest increase among expense categories, rising by \$3.1 million, or 262%, for the third quarter of 2010 relative to the third quarter of 2009, and by \$3.7 million, or 169%, for the first nine months. The main drivers of the increase in loan services costs were expenses associated with foreclosed assets, which consist primarily of write-downs on OREO s to reflect lower values on recent appraisals, but also include foreclosed asset operating expenses such as property taxes, insurance, property management fees, and maintenance costs. OREO write-downs totaled \$3.9 million in the third quarter of 2010 relative to \$824,000 in the third quarter of 2009, an increase of over \$3.0 million, and were \$4.5 million in the first nine months of 2010 relative to \$1.2 million in the first nine months of 2009, an increase of \$3.3 million. The increase in OREO write-downs is due mainly to a \$3 million adjustment made to the carrying value of a single property in the third quarter of 2010, subsequent to the receipt of an updated appraisal. Foreclosed asset operating expenses totaled \$256,000 in the third quarter of 2010 as compared to \$65,000 in the third

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quarter of 2009, an increase of \$191,000, and were \$892,000 in the first nine months of 2010 relative to \$337,000 in the first nine months of 2009, an increase of \$555,000.

Legal and accounting costs fell \$194,000, or 43%, for the quarter, and were down \$242,000, or 21%, for the year-to-date period, due to accrual adjustments made with regard to updated expectations for legal expense and the cost of external reviews. Other professional service expense declined by \$387,000, or 27%, for the third quarter, and by \$800,000, or 23%, for the first nine months, due mainly to a lower FDIC assessment. The FDIC assessment reflects a drop of \$454,000 for the quarter due to accrual adjustments, partially to factor in a declining assessment base in 2010, and a drop of \$745,000 for the first nine months because of the accrual adjustments as well as the \$595,000 special assessment in the second quarter of 2009. Also impacting other professional service expense were declines of \$16,000 and \$156,000 in directors' deferred compensation accruals for the third quarter and first nine months, respectively, due again to a lower level of net gains on directors' deferred fee balances in 2010 relative to 2009.

Because of the disproportionate increase in overhead expense, the Company's tax-equivalent overhead efficiency ratio increased to 76.10% in the third quarter of 2010 from 54.81% in the third quarter of 2009, and increased to 67.35% in the first nine months of 2010 from 58.21% in the first nine months of 2009. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains/losses, and other extraordinary gains/losses excluded from the equation.

PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company's statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. The Company's tax credits consist primarily of those generated by our \$10.6 million investment in low-income housing tax credit funds, and California state employment tax credits. The Company had an income tax accrual reversal of \$787,000 in the third quarter of 2010, relative to a reversal of \$1.4 million in the third quarter of 2009. The negative income tax provision for the third quarters of 2010 and 2009 helped boost net income for both quarters. This is the result of a relatively high level of tax credits, which had a greater impact than might be expected due to the favorable effect of tax-exempt interest income and BOLI income on pre-tax income. Our tax credits stem from investments in low-income housing tax credit funds, as well as hiring tax credits. The Company's income tax provision was only \$27,000 for the first nine months of 2010, and it was negative for the first nine months of 2009 in spite of positive pre-tax income because tax credits exceeded our tax liability. Our tax accrual rate is currently very sensitive to changes in pretax income, because of our level of permanent differences relative to pretax income.

BALANCE SHEET ANALYSIS

EARNING ASSETS

INVESTMENTS

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

The Company's investments consist of debt and marketable equity securities (together, the investment portfolio), investments in the time deposits of other banks, and overnight fed funds sold. Fed funds sold represent the investment of temporary excess liquidity with one or more correspondent banks. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they

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can provide partially tax exempt income. Aggregate investments were 25% of total assets at September 30, 2010, and 23% at December 31, 2009.

We had \$478,000 in fed funds outstanding at September 30, 2010, and none at December 31, 2009. Furthermore, our balance of interest-bearing balances at other banks was only \$325,000 at September 30, 2010, down substantially from the \$32 million balance at the end of 2009. The balance was relatively high at year-end 2009, because excess balance sheet liquidity was placed in our Federal Reserve Bank account at higher yields than could be realized by selling fed funds. The book balance of the Company's investment portfolio increased by \$40 million, or 14%, during the first nine months of 2010, as the excess liquidity that was parked in our Federal Reserve Bank account at year-end was redeployed into longer-term, higher-yielding 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 value, with monthly tax-effected mark-to-market adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity. The following table sets forth the Company's investment portfolio by investment type as of the dates noted:

Investment Portfolio

| | September 30, 2010 | | December 31, 2009 | |
|-----------------------------------|--------------------|-------------------|-------------------|-------------------|
| | Amortized Cost | Fair Market Value | Amortized Cost | Fair Market Value |
| (dollars in thousands, unaudited) | | | | |
| Available for Sale | | | | |
| US Treasury securities | \$ | \$ | \$ | \$ |
| US Gov't agencies | 5,084 | 5,222 | 6,728 | 6,861 |
| Mortgage-backed securities | 236,385 | 239,419 | 201,534 | 206,801 |
| Corporate Bonds | 27 | 27 | | |
| State & political subdivisions | 69,198 | 72,116 | 62,506 | 63,138 |
| Other equity securities | 2,705 | 1,248 | 2,705 | 1,368 |
| Total Investment Securities | \$ 313,399 | \$ 318,032 | \$ 273,473 | \$ 278,168 |

Mortgage-backed securities increased by \$33 million, or 16%, net of prepayments, for the first nine months of 2010. As noted above, the Company sold \$66 million in mortgage-backed securities in the third quarter of 2010, realizing \$2.6 million in gains. We reinvested the proceeds in similar but larger-denominated agency-issued mortgage-backed securities, which have slightly lower yields and a slightly longer average duration. The balance of municipal bonds has increased by \$9 million, or 14%, as the Company has taken advantage of relative value in that sector. It should be noted that all newly purchased municipal bonds have strong underlying ratings. US Government Agency securities fell by \$2 million, because maturing balances were not replaced. No equity securities were bought or sold during the first nine months of 2010, although the market value of those securities declined slightly. Investment portfolio securities that were pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled \$145 million at September 30, 2010 and \$213 million at December 31, 2009, leaving \$172 million in unpledged debt securities at September 30, 2010 and \$64 million at December 31, 2009. Securities pledged in excess of actual pledging needs, and thus available for liquidity purposes if necessary, totaled \$54 million at September 30, 2010 and \$17 million at December 31, 2009. The large increase in our unpledged and excess pledged securities is the result of an FHLB letter of credit that was obtained in the second quarter of 2010 to satisfy certain pledging needs, freeing up investment securities that were previously used for that purpose.

At September 30, 2010 and December 31, 2009, the Company had 68 securities and 79 securities, respectively, with unrealized losses. Management has evaluated these securities as of the respective dates, and does not believe that any of the associated

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unrealized losses are other than temporary. Information pertaining to these investment securities, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| | September 30, 2010 | | | |
|---|---------------------|-------------------------------|-----------------|-------------------------------|
| | Less than 12 Months | | Over 12 Months | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| (dollars in thousands, unaudited) | | | | |
| US Treasuries | \$ | \$ | \$ | \$ |
| US Government Agencies | | | | |
| Obligations of State and Political Subdivisions | 1,484 | (7) | 2,802 | (138) |
| Agency-Issued Mortgage-Backed Securities (MBS) | 100,706 | (875) | | |
| Private-Label MBS | | | 774 | (30) |
| Other Securities | | | 1,248 | (1,458) |
| TOTAL | \$ 102,190 | \$ (882) | \$ 4,824 | \$ (1,626) |

| | December 31, 2009 | | | |
|---|---------------------|-------------------------------|-----------------|-------------------------------|
| | Less than 12 Months | | Over 12 Months | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| (dollars in thousands, unaudited) | | | | |
| US Treasuries | \$ | \$ | \$ | \$ |
| US Government Agencies | | | | |
| Obligations of State and Political Subdivisions | 11,400 | (409) | 2,807 | (180) |
| Agency-Issued Mortgage-Backed Securities (MBS) | 25,288 | (108) | | |
| Private-Label MBS | | | 1,080 | (95) |
| Other Securities | 1,368 | (1,341) | | |
| TOTAL | \$ 38,056 | \$ (1,858) | \$ 3,887 | \$ (275) |

LOAN PORTFOLIO

The Company's loans and leases, gross of the associated allowance for losses and deferred fees and origination costs, totaled \$827 million at the end of September 2010, a drop of \$57 million, or 6%, since December 31, 2009. Loan balances have been declining because of runoff in the normal course of business (including prepayments), charge-offs, transfers to OREO, and loan sales. Furthermore, loan origination activity in our branches has been light due to weak demand from creditworthy borrowers, tightened credit criteria for real estate loans, and increased attention devoted to monitoring and managing current loan relationships. Management has realigned branch objectives in order to place additional emphasis on high-quality loan growth, with a particular focus on commercial loans, but no assurance can be provided that loan balances will not continue to decline, especially in the near term. A comparative schedule of the distribution of the Company's loans at September 30, 2010 and December 31, 2009, by outstanding balance as well as by percentage of total loans, is presented in the following Loan and Lease Distribution table. The balances shown for each loan type are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs for loans in that category.

Table of Contents**Loan and Lease Distribution**

| (dollars in thousands, unaudited) | September 30, 2010 | December 31, 2009 |
|-------------------------------------|-----------------------|----------------------|
| Real Estate: | | |
| 1-4 family residential construction | 14,834 | 16,587 |
| Other Construction/Land | 64,220 | 100,289 |
| 1-4 family closed-end | 107,962 | 117,115 |
| Equity Lines | 70,694 | 69,701 |
| Multi-family residential | 10,125 | 8,164 |
| Commercial RE owner occupied | 186,372 | 188,592 |
| Commercial RE non-owner occupied | 117,335 | 105,682 |
| Farmland | 67,334 | 61,098 |
| Total Real Estate | 638,876 | 667,228 |
| Agricultural products | 10,214 | 10,136 |
| Commercial and Industrial | 99,761 | 117,423 |
| Small Business Administration Loans | 19,022 | 18,626 |
| Direct finance leases | 11,698 | 15,394 |
| Consumer loans | 47,707 | 55,799 |
| Total Loans and Leases | \$ 827,278 | \$ 884,606 |

Percentage of Total Loans and Leases

| | | |
|-------------------------------------|----------------|----------------|
| Real Estate: | | |
| 1-4 family residential construction | 1.79% | 1.88% |
| Other Construction/land | 7.76% | 11.33% |
| 1-4 family closed-end | 13.04% | 13.24% |
| Equity Lines | 8.56% | 7.88% |
| Multi-family residential | 1.22% | 0.92% |
| Commercial RE owner occupied | 22.52% | 21.32% |
| Commercial RE non-owner occupied | 14.18% | 11.95% |
| Farmland | 8.15% | 6.91% |
| Total Real Estate | 77.22% | 75.43% |
| Agricultural products | 1.23% | 1.15% |
| Commercial and Industrial | 12.06% | 13.27% |
| Small Business Administration Loans | 2.31% | 2.10% |
| Direct finance leases | 1.41% | 1.74% |
| Consumer loans | 5.77% | 6.31% |
| Total Loans and Leases | 100.00% | 100.00% |

Agricultural production loans were about even relative to their year-end 2009 balance, and SBA loan balances increased slightly, but balances declined in the total real estate, commercial, direct finance lease, and consumer loan categories. While aggregate real estate loan balances were down, within that category non-owner occupied commercial real estate loans increased by \$12 million, or 11%, due to the completion of construction projects and the reclassification of associated loans as commercial real estate loans. That reclassification contributed to the decline in other construction/land loan balances, which were down by \$36 million for the first nine months of 2010. The only categories within real estate to experience genuine growth were loans secured by farmland, which increased by \$6 million, or 10%, and multi-family residential loans, which were up by \$2 million, or 24%. Commercial loans and consumer loans also experienced fairly substantial drops in outstanding balances during the first nine months of 2010, declining by \$18 million, or 15%, and \$8 million, or 15%, respectively. For both commercial and consumer loans the decline is primarily the result of flagging demand, but it also includes over \$4 million in commercial loan charge-offs and almost \$3 million in consumer loan charge-offs.

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Our total investment in impaired loans was \$76.2 million at September 30, 2010. Pursuant to FASB's impairment accounting guidance, 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 from the borrower in accordance with the contractual terms of the loan. Impaired loans include all nonperforming loans, as well as certain other loans that are still being maintained on accrual status including performing restructured troubled debt.

Although not reflected in the loan totals above, the Company occasionally originates and sells, or participates out portions of, certain commercial real estate loans, agricultural or residential mortgage loans, and other loans to non-affiliated investors, and we currently provide servicing for some of those loans including a small number of SBA loans. The balance of loans serviced for others fell to \$5 million at September 30, 2010 from \$8 million at December 31, 2009, with the decline resulting primarily from winding down servicing for agricultural mortgage loans that had been previously sold by the Company with servicing rights retained.

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OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company makes commitments to extend credit as long as there are no violations of any conditions established in the outstanding contractual arrangement. Unused commitments to extend credit totaled \$139 million at September 30, 2010 as compared to \$162 million at December 31, 2009, although it is not likely that all of these commitments will ultimately be drawn down. Unused commitments represented approximately 17% of gross loans outstanding at September 30, 2010, and 18% at December 31, 2009. In addition to unused loan commitments, the Company had letters of credit totaling \$17 million at September 30, 2010 and \$21 million at December 31, 2009.

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

NONPERFORMING ASSETS

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and other real estate owned. OREO consists of properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt exists with regard to the ability of the Company to collect all principal and interest on a loan or lease. At that point, we stop accruing interest on the loan or lease in question, and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for a period of 90 days or more is also placed on non-accrual status, even if interest is still being received, unless the asset is both well secured and in the process of collection. Nonperforming assets are considered to be impaired, as explained above in the Loan Portfolio section. If the Bank grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring (TDR). TDRs are also deemed to be impaired loans, and are further classified as either nonperforming or performing loans depending on their accrual status. The following table presents comparative data for the Company's nonperforming assets and performing TDRs:

Table of ContentsNonperforming Assets

| (dollars in thousands, unaudited) | September 30, 2010 | December 31, 2009 |
|---|-----------------------|----------------------|
| NON-ACCRUAL LOANS: | | |
| Real Estate: | | |
| 1-4 family residential construction | \$ 4,083 | \$ 1,223 |
| Other Construction/Land | \$ 10,292 | 18,005 |
| 1-4 family closed-end | \$ 3,771 | 4,790 |
| Equity Lines | \$ 364 | 626 |
| Multi-family residential | \$ | 236 |
| Commercial RE owner occupied | \$ 8,715 | 3,964 |
| Commercial RE non-owner occupied | \$ 16,568 | 8,650 |
| Farmland | \$ 408 | 429 |
| TOTAL REAL ESTATE | 44,201 | 37,923 |
| Agricultural products | | |
| Commercial and Industrial | 2,262 | 3,559 |
| Small Business Administration Loans | 3,258 | 3,683 |
| Direct finance leases | 572 | 1,053 |
| Consumer loans | 1,171 | 756 |
| TOTAL NONPERFORMING LOANS | \$ 51,464 | \$ 46,974 |
| Foreclosed assets | 25,898 | 25,654 |
| Total nonperforming assets | \$ 77,362 | \$ 72,628 |
| Performing loans classified as troubled debt restructurings (TDR ⁽¹⁾) | \$ 12,042 | \$ 28,024 |
| Nonperforming loans as a % of total gross loans and leases | 6.22% | 5.31% |
| Nonperforming assets as a % of total gross loans and leases and foreclosed assets | 9.07% | 7.98% |

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

Total nonperforming assets increased \$4.7 million, or 7%, during the first nine months of 2010. Of that increase, \$4.5 million was in nonperforming loans, and \$244,000 was in foreclosed assets. The balance of nonperforming loans at September 30, 2010 includes a total of \$20.9 million in TDR s which were paying as agreed under modified terms or forbearance agreements but were still classified as nonperforming. As shown in the table, we also had \$12.0 million in loans classified as performing TDR s for which we were still accruing interest at September 30, 2010, a drop of \$16.0 million relative to the balance at December 31, 2009. The decline in performing TDR s is primarily the result of a single developer relationship of over \$4 million in loans secured by residential properties, and a \$7 million agricultural loan secured by real estate, which are paying interest at market rates and are now well-seasoned, and were thus removed from the TDR classification in the first quarter of 2010. Additionally, during the third quarter of 2010, we moved a \$3 million loan from the performing TDR category to non-accrual status since the collection of a portion of the outstanding principal is in doubt, although the borrower is still paying interest as agreed.

Non-accruing loan balances secured by real estate comprised \$44.2 million of total nonperforming loans at September 30, 2010, and reflect a net increase of \$6.3 million, or 17%, during the first nine months of 2010. Gross additions to nonperforming real estate loans totaled \$36.2 million for the year-to-date period, much of which was comprised of balances secured by commercial real estate, but the increase also includes relatively large increases in the other construction/land, 1-4 family residential construction, and 1-4 family closed-end categories. Offsetting some of the increase created by additional real estate loans placed on non-accrual status during the first nine months of 2010 were \$10.1 million in transfers to OREO from nonperforming real estate loans, net pay-downs on nonperforming real estate loans of \$7.9 million, \$4.7 million in real estate

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loans that were returned to accrual status, and charge-offs of \$7.3 million.

Nonperforming commercial and SBA loans declined by a combined \$1.7 million, or 24%, during the first nine months of 2010, ending the period at \$5.5 million. Gross additions to nonperforming commercial and SBA loans totaled \$6.6 million for the first nine months, but this was offset by net pay-downs of \$1.3 million, the return to accrual status of \$2.4 million in loans, the charge-off of \$4.0 million in loan balances, and the transfer of a small amount to foreclosed assets. Non-accrual direct finance leases declined by

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\$481,000, or 46%, in the first nine months of 2010, since balances charged off exceeded net additions. Nonperforming consumer loans, which are largely unsecured, increased by \$415,000, or 55%, to a total of \$1.2 million.

The balance of foreclosed assets at September 30, 2010 had an aggregate carrying value of \$25.9 million, and was comprised of 86 separate parcels classified as OREO and 18 mobile homes. Much of our OREO consists of vacant lots or land, but there are also 26 residential properties totaling \$7.8 million, five commercial buildings with a combined book balance of \$2.6 million, and a mini-storage unit. At the end of 2009, foreclosed assets totaled \$25.7 million, comprised of 85 properties in OREO, 13 mobile homes, and a small amount of commercial equipment acquired upon the default of a lease agreement. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value.

Nonperforming assets were 9.07% of total gross loans and leases plus foreclosed assets at September 30, 2010, up from 7.98% at December 31, 2009. While our balance of nonperforming assets has increased since year-end 2009, an action plan is in place for each of our nonperforming and foreclosed assets and they are all being actively managed. Collection efforts are continuously pursued for all nonperforming loans, but we cannot provide assurance that all will be resolved in a timely manner or that nonperforming balances will not increase further.

ALLOWANCE FOR LOAN AND LEASE LOSSES

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses based on management's evaluation of probable loan losses related to certain specifically identified loans, as well as probable incurred loan losses in the remaining loan portfolio. It is maintained at a level which is adequate to absorb remaining probable loan losses after factoring in charge-offs taken against the allowance, and recoveries credited back to the allowance. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. At September 30, 2010, the allowance for loan and lease losses was \$19.8 million, or 2.40% of gross loans, a 16% decline from the \$23.7 million allowance at December 31, 2009 which was 2.68% of gross loans. The allowance declined by \$3.5 million, or 15%, in comparison to September 30, 2009, when it was 2.57% of gross loans. The Company's total allowance was 38.54% of nonperforming loans at September 30, 2010, relative to 50.49% at December 31, 2009 and 41.50% at September 30, 2009. An allowance for potential losses inherent in unused commitments, totaling \$160,000 at September 30, 2010, is included in other liabilities.

We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it on at least a quarterly basis. Pursuant to that methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary, representing the difference between the face value of the loan and either its current appraised value less estimated disposition costs, or its net present value as determined by a discounted cash flow analysis. While we had a total of \$76.2 million in impaired loans on our books at September 30, 2010, impaired loans totaling approximately \$46.5 million did not require any valuation allowance either because they have already been written down to their estimated fair values, or because the fair value of the collateral or the net present value of anticipated cash flows exceeded the carrying value of those loans. Thus, our total impaired loan valuation allowance of \$6.3 million at September 30, 2010 is applicable to remaining \$29.7 million balance of impaired loans.

On impaired loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition of underlying collateral, impairment is measured using the net present value of expected cash flows relative to the loan's remaining book balance. If a distressed borrower displays the desire and ability to continue paying on the loan, but is unable to do so except on a modified basis, an amended repayment plan may be negotiated. For these TDRs, the act of modification in and of itself suggests that the Company believes the source of repayment will likely be from borrower cash flows, thus they are also typically evaluated for impairment by discounting projected cash flows.

For loans where repayment is expected to be provided solely by the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition, is less than the loan balance, then a specific loss reserve is established for the amount of the collateral coverage shortfall. If the discounted collateral value is greater than or equal to

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the loan balance, no specific loss reserve is established. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal was not already available. We generally use external appraisals to determine the fair value of the underlying collateral for nonperforming real estate loans, although the Company's licensed staff appraisers may update older appraisals based on current market conditions and property value trends. Until an updated appraisal is received, the Company uses the existing appraisal to determine the amount of the specific loss allowance that may be required, and adjusts the specific loss allowance, as necessary, once a new appraisal is received. Updated appraisals are generally ordered at least annually for collateral-dependent loans that remain impaired. Current appraisals were available for 64% of the Company's impaired loans at September 30, 2010. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if such costs were not reflected in appraised values. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Based on our detailed evaluation of individual nonperforming real estate loans on our books at September 30, 2010, approximately \$6.7 million in probable losses have been identified. An allowance was established for that amount, although losses totaling \$4.2 million have been identified as uncollectible and were written off against that allowance. After the aforementioned write-downs there is a \$2.5 million allowance remaining for \$12.0 million in nonperforming real estate loans as of September 30, 2010, with another \$32.2 million in nonperforming real estate loans requiring no allowance because the fair value of the collateral or net present value of expected cash flows exceeds the book value of the loans. The loss allowance established for specifically identified probable losses for other nonperforming loan categories, including commercial loans and leases, SBA loans, and consumer loans, totaled \$3.1 million on loan balances of \$7.3 million at September 30, 2010.

Our methodology also provides that an allowance be established for probable incurred losses inherent in performing loans and leases, which are segregated by substandard or other status and then evaluated either individually or in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical data, projected cash flows and other objective information, the classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on management's judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that management believes is appropriate at each reporting date. Quantitative information includes our historical loss experience, delinquency and charge-off trends, current collateral values, and the anticipated timing of collection of principal for nonperforming loans. Qualitative factors include the general economic environment in our markets and, in particular, the state of the agricultural industry and other key industries in the Central San Joaquin Valley. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The allowance established for probable incurred losses for performing loans was \$14.3 million at September 30, 2010.

There have been no recent material changes to the methodology used to determine our allowance for loan and lease losses, although we did make adjustments to certain qualitative factors in September 2010 in anticipation of the impact of recent relatively high loan losses on historical loss rates. As we add new products and expand our geographic coverage, and as the economic environment changes, we expect to continue to enhance our methodology to keep pace with the size and complexity of the loan and lease portfolio and respond to pressures created by external forces. We engage outside firms on a regular basis to assess our methodology and perform independent credit reviews of our loan and lease portfolio. In addition, the Company's external auditors, the FDIC, and the California DFI review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity.

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

Allowance for Loan and Lease Losses

| (dollars in thousands, unaudited) | For the Quarter Ended | | For the Nine-Month Period Ended | | For the Year Ended |
|---|-----------------------|-------------------|---------------------------------|-------------------|--------------------|
| | September 30 2010 | September 30 2009 | September 30 2010 | September 30 2009 | December 31 2009 |
| Balances: | | | | | |
| Average loans and leases outstanding during period ⁽¹⁾ | \$ 843,967 | \$ 923,513 | \$ 862,591 | \$ 934,689 | \$ 926,326 |
| Gross loans and leases outstanding at end of period | \$ 827,278 | \$ 909,485 | \$ 827,278 | \$ 909,485 | \$ 884,606 |
| Allowance for Loan and Lease Losses: | | | | | |
| Balance at beginning of period | \$ 24,874 | \$ 16,358 | \$ 23,715 | \$ 15,094 | \$ 15,094 |
| Provision charged to expense | 6,380 | 10,473 | 13,280 | 17,976 | 21,574 |
| Charge-offs | | | | | |
| Real Estate: | | | | | |
| 1-4 family residential construction | 1,706 | 82 | 1,706 | 536 | 536 |
| Other Construction/Land | 3,971 | 581 | 4,238 | 2,030 | 2,598 |
| 1-4 Family closed-end | 793 | 537 | 1,058 | 1,444 | 1,650 |
| Equity Lines | 308 | 84 | 334 | 399 | 695 |
| Multi-family residential | | | 97 | | |
| Commercial RE owner occupied | 347 | 26 | 919 | 26 | 26 |
| Commercial RE non-owner occupied | 1,245 | | 1,358 | | |
| Farmland | 26 | | 26 | | |
| TOTAL REAL ESTATE | 8,396 | 1,310 | 9,736 | 4,435 | 5,505 |
| Agricultural products | | | | | 524 |
| Commercial and Industrial | 2,269 | 915 | 4,485 | 2,623 | 3,747 |
| Small Business Administration Loans | 39 | (79) | 139 | 45 | |
| Direct Finance Leases | 102 | | 607 | 97 | 97 |
| Consumer Loans | 867 | 1,609 | 2,855 | 3,323 | 4,531 |
| Total | 11,673 | 3,755 | 17,822 | 10,523 | 14,404 |
| Recoveries | | | | | |
| Real Estate: | | | | | |
| 1-4 family residential construction | | | 25 | 174 | 271 |
| Other Construction/Land | 13 | 87 | 13 | 93 | 241 |
| 1-4 Family closed-end | 26 | 2 | 32 | 7 | 10 |
| Equity Lines | 1 | 1 | 40 | 1 | 2 |
| Multi-family residential | | | | | |
| Commercial RE owner occupied | | | | | |
| Commercial RE non-owner occupied | | | | | |
| Farmland | | | | | |
| TOTAL REAL ESTATE | 40 | 90 | 110 | 275 | 524 |
| Agricultural products | | | | | |
| Commercial and Industrial | 98 | 159 | 189 | 295 | 549 |
| Small Business Administration Loans | 3 | 1 | 63 | 75 | |
| Direct Finance Leases | 56 | | 68 | 5 | 103 |
| Consumer Loans | 56 | 37 | 231 | 166 | 275 |
| Total | 253 | 287 | 661 | 816 | 1,451 |

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| | | | | | |
|-----------------------------------|-----------|-----------|-----------|-----------|-----------|
| Net loan charge offs (recoveries) | 11,420 | 3,468 | 17,161 | 9,707 | 12,953 |
| Balance | \$ 19,834 | \$ 23,363 | \$ 19,834 | \$ 23,363 | \$ 23,715 |

RATIOS

| | | | | | |
|--|---------|--------|---------|--------|--------|
| Net Charge-offs to Average Loans and Leases (annualized) | 5.37% | 1.49% | 2.66% | 1.39% | 1.40% |
| Allowance for Loan Losses to Gross Loans and Leases at End of Period | 2.40% | 2.57% | 2.40% | 2.57% | 2.68% |
| Allowance for Loan Losses to Non-Performing Loans | 38.54% | 41.50% | 38.54% | 41.50% | 50.49% |
| Net Loan Charge-offs to Allowance for Loan Losses at End of Period | 57.58% | 14.84% | 86.52% | 41.55% | 54.62% |
| Net Loan Charge-offs to Provision for Loan Losses | 179.00% | 33.11% | 129.22% | 54.00% | 60.04% |

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

As shown in the table, the Company's provision for loan and lease losses fell by \$4.1 million, or 39%, for the quarter, and by \$4.7 million, or 26%, for the year-to-date period. On the surface, the decline in our loan loss provision appears directionally inconsistent with net charge-offs, which increased \$8.0 million, or 229%, for the quarter, and \$7.5 million, or 77%, for the year-to-date period. However, as previously discussed, many of the loan charge-offs were against specific reserves that had been established in prior periods and thus did not create the need for reserve replenishment. Real estate loan charge-offs experienced the largest increase

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among our principal loan categories, rising by \$5.3 million, or 120%, for the comparative year-to-date periods, due mainly to write-downs subsequent to the determination that certain balances had become uncollectible. As noted above, we have taken a total of \$4.2 million in write-downs on collateral-dependent loans still on our books at September 30, 2010, most of which were on construction loans. Charge-offs for the year-to-date period also increased by \$1.9 million, or 71%, for commercial loans, by \$94,000, or 209%, for SBA loans, and by \$510,000, or 526%, for direct finance leases. Consumer loan charge-offs, on the other hand, declined by \$468,000, or 14%. Material changes in the level of principal recoveries are not evident for any category. Since our allowance for loan and lease losses is maintained at a level to cover probable losses related to specifically identified loans as well as probable incurred losses in the remaining loan portfolio, any shortfall in the allowance created by loan charge-offs is typically covered by month-end, and always by quarter-end. Additional details on our provision for loan and lease losses, and its relationship to actual charge-offs, is contained above in the [Provision for Loan and Lease Losses](#) section.

The Company's allowance for loan and lease losses at September 30, 2010 represents management's best estimate of probable loan losses related to specifically identified loans, as well as probable incurred loan losses in the remaining loan portfolio. Fluctuations in credit quality, changes in economic conditions, or other factors could induce us to augment the allowance, however, and no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance.

OTHER ASSETS

The balance of non-interest earning cash and due from banks was \$41 million at September 30, 2010, compared to \$34 million at December 31, 2009. Since the actual balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks), it is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Home Loan Bank of San Francisco. Should a large short overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a long position is prevalent, the Company will, to the extent possible, let brokered deposits or other wholesale borrowings roll off as they mature.

Because of frequent balance fluctuations, a more accurate gauge of cash management efficiency is the average balance for the period. The \$32.6 million average of cash and due from banks for the first nine months of 2010 was higher than the \$30.5 million average for all of 2009, due primarily to the addition of branches in October 2009 and March 2010. Average cash balances have been well-controlled due to close monitoring and effective management of branch cash levels.

Net premises and equipment increased by only \$59,000, or less than 1%, during the first nine months of 2010, since additions related to improvements on our new Farmersville branch were largely offset by the increase in accumulated depreciation on other buildings and equipment. Other assets were \$1.5 million higher, with the most significant changes including a \$3.4 million increase in current prepaid taxes and a \$1.0 million increase in bank-owned life insurance due to the addition of income earned, partially offset by a drop in our prepaid FDIC assessment subsequent to payments made in the first nine months of 2010, and small declines in operating leases, restricted stock, low-income housing tax credit investments and accrued interest receivable. At September 30, 2010, the \$112 million balance of other assets includes as its largest components \$31 million in bank-owned life insurance (see discussion of BOLI in [Non-Interest Revenue and Operating Expense](#) section above), an \$11 million investment in low-income housing tax credit funds, approximately \$26 million in OREO and other foreclosed assets, a \$9 million investment in restricted stock, a deferred tax asset of \$9 million, current prepaid income taxes totaling \$4 million, accrued interest receivable totaling \$5 million, goodwill of about \$6 million, a prepaid FDIC assessment of \$5 million, and \$1 million in operating leases. Restricted stock is comprised primarily of FHLB stock that typically experiences balance fluctuations in conjunction with our level of FHLB borrowings. However, the FHLB of San Francisco suspended stock repurchases for a period of time and only recently started to repurchase stock at minimal levels, thus our \$8 million FHLB stock investment is not expected to drop significantly even though our borrowings have declined. This stock is not deemed to be marketable or liquid and is thus not grouped with the Company's investments described above. The Company's goodwill is evaluated annually for potential impairment, and because the estimated fair value of the Company exceeded its book value (including goodwill) as of the measurement date and no impairment was indicated, no further testing was deemed necessary and it was determined that no goodwill impairment exists. Likewise, our net deferred tax asset is evaluated as of every reporting date pursuant to FASB guidance, and we have determined that no impairment exists.

Table of Contents**DEPOSITS AND INTEREST BEARING LIABILITIES****DEPOSITS**

Another key balance sheet component impacting the Company's net interest margin is our deposit base. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly core deposits, which include demand deposit accounts, interest-bearing demand accounts (NOW accounts), savings accounts, money market demand accounts (MMDA's), and non-brokered time deposits under \$100,000. Information concerning average balances and rates paid on deposits by deposit type for the quarters and nine-month periods ended September 30, 2010 and 2009 is contained in the Average Rates and Balances tables appearing above in the section titled Net Interest Income and Net Interest Margin. A comparative schedule of the distribution of the Company's deposits at September 30, 2010 and December 31, 2009, by outstanding balance as well as by percentage of total deposits, is presented in the following Deposit Distribution table.

Deposit Distribution

| (dollars in thousands, unaudited) | September 30, 2010 | December 31, 2009 |
|------------------------------------|-----------------------|----------------------|
| Demand | \$ 245,424 | \$ 233,204 |
| NOW | 181,771 | 151,821 |
| Savings | 72,266 | 62,279 |
| Money Market | 152,296 | 165,097 |
| CDAR's < \$100,000 | 1,926 | 12,937 |
| CDAR's ≥ \$100,000 | 40,687 | 129,194 |
| Customer Time Deposit < \$100,000 | 197,619 | 147,390 |
| Customer Time deposits ≥ \$100,000 | 197,566 | 195,510 |
| Brokered Deposits | | 28,000 |
| Total Deposits | \$ 1,089,555 | \$ 1,125,432 |

Percentage of Total Deposits

| | | |
|------------------------------------|---------|---------|
| Demand | 22.53% | 20.72% |
| NOW | 16.68% | 13.49% |
| Savings | 6.63% | 5.53% |
| Money Market | 13.98% | 14.67% |
| CDAR's < \$100,000 | 0.18% | 1.15% |
| CDAR's ≥ \$100,000 | 3.73% | 11.48% |
| Customer Time Deposit < \$100,000 | 18.14% | 13.10% |
| Customer Time deposits ≥ \$100,000 | 18.13% | 17.37% |
| Brokered Deposits | 0.00% | 2.49% |
| Total | 100.00% | 100.00% |

Total deposit balances dropped by \$36 million, or 3%, during the first nine months of 2010, but our deposit mix has substantially improved with migration out of brokered deposits and jumbo time deposits into core deposits. Core non-maturity deposits were up by \$39 million, or 6%, and customer time deposits under \$100,000 increased by \$50 million, or 34%. The growth in non-maturity deposits is due in part to our aggressive deposit acquisition programs: Direct mail initiatives continue to provide top-of-mind brand and product awareness for businesses and consumers who might be considering a transition in banking relationships, our online checking product has been successful in generating growth in NOW deposits, and a dedicated sales group focused on business deposits has favorably impacted growth in non-interest bearing demand deposits. During the first nine months of 2010, non-interest bearing demand deposits rose \$12 million, or 5%, NOW deposits grew by \$30 million, or 20%, savings deposits were up \$10 million, or 16%, while money market deposit balances declined by \$13 million, or 8%. Customer-sourced time deposits over \$100,000 increased by \$2 million, or 1%. CDAR's deposits, however, which are also primarily sourced from customers in our

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market areas, declined by a combined total of almost \$100 million, or 70%, due primarily to the fact that we have managed down balances from larger depositors to reduce our exposure to potential single-customer withdrawals and better control our liquidity position. Wholesale-sourced brokered deposits declined \$28 million during the first nine months of 2010, to a balance of zero at September 30, 2010. Management does not anticipate that it will be necessary to replace matured balances with additional brokered deposits in the near future.

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Management recognizes that maintaining a high level of core customer deposits is one of the keys to sustaining a strong net interest margin, and as noted we continue to focus energy in that direction. Our deposit-centric marketing efforts appear to be having a positive impact, with an inflow of deposit dollars from current customers who are placing renewed value on the safety and security of insured deposits, as well as from new customers who have sought a more stable and secure option for their money. However, no assurance can be provided that these favorable trends will continue.

OTHER INTEREST-BEARING LIABILITIES

The Company's other interest-bearing liabilities include overnight borrowings from other banks (fed funds purchased), borrowings from the Federal Home Loan Bank, securities sold under agreement to repurchase, and junior subordinated debentures that consist entirely of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities (see Capital Resources section for a more detailed explanation of trust-preferred securities).

The Company uses overnight and short-term FHLB advances and overnight fed funds purchased on uncommitted lines from correspondent banks to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit is dependent on the level of pledged collateral. There were no borrowings under repurchase agreements or overnight fed funds purchased outstanding at September 30, 2010 or December 31, 2009. Overnight FHLB advances totaled \$7 million at September 30, 2010, up from zero at the end of 2009, but term FHLB advances declined by \$10 million during the same time frame. As of September 30, 2010, term FHLB borrowings totaled \$20 million, comprised of \$5 million in short-term advances (excluding overnight FHLB advances) and \$15 million in the form of longer-term borrowings (remaining maturity over one year). The Company had \$31 million in junior subordinated debentures at September 30, 2010 and December 31, 2009.

OTHER NON-INTEREST BEARING LIABILITIES

Other non-interest bearing liabilities are principally comprised of accrued interest payable, accrued income taxes, other accrued but unpaid expenses, and certain clearing amounts. Other liabilities dropped by \$866,000, or 6%, during the first nine months of 2010, due mainly to a reduction in our reserve for current taxes subsequent to the payment of taxes.

LIQUIDITY AND MARKET RISK MANAGEMENT

LIQUIDITY

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

The Company, on occasion, experiences short-term cash needs as the result of loan growth or deposit outflows, or other asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, or solicit brokered deposits if deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks, including the Federal Home Loan Bank, totaled \$99 million at September 30, 2010. An additional \$153 million in credit is available from the Federal Home Loan Bank if the Company pledges additional real-estate related collateral in a like amount and maintains the required amount of FHLB stock. The Company is also eligible to borrow approximately \$66 million at the Federal Reserve Discount Window, if necessary, based on pledged assets at September 30, 2010. Further, funds can be obtained by drawing down the Company's correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase

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those investments in its portfolio which are not pledged as collateral. As of September 30, 2010, unpledged securities, plus pledged securities in excess of current pledging requirements, comprised \$226 million of the Company's investment portfolio balances. Other forms of balance sheet liquidity include but are not necessarily limited to fed funds sold, vault cash, and balances due from banks. The Company experienced a significant shift from contingent liquidity to actual balance sheet liquidity in the second quarter of 2010, due to the arrangement of a letter of credit from the FHLB for certain pledging requirements in place of investment securities. The FHLB letter of credit totaled \$163 million at September 30, 2010. Management is of the opinion that its investments and other potentially liquid assets, along with other standby funding sources it has arranged, are more than sufficient to meet the Company's current and anticipated short-term liquidity needs.

The Company's primary liquidity and average loans to assets ratios were 28% and 61%, respectively, at September 30, 2010, as compared to internal policy guidelines of greater than 8% and less than 78%. The liquidity ratio is calculated with the balance of cash and due from banks, plus available investment securities and committed available-for-sale loans as the numerator, and non-collateralized deposits and short-term liabilities as the denominator. Other liquidity ratios reviewed by management and the Board include average net loans to core deposits, net non-core funding dependence, and reliance on wholesale funding, all of which were well within policy guidelines at September 30, 2010. Strong growth in core deposits combined with loan runoff and growth in investments has had a positive impact on our liquidity position in recent periods, although no assurance can be provided that this will continue to be the case.

INTEREST RATE RISK MANAGEMENT

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management (sometimes referred to as asset/liability management) is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. To identify areas of potential exposure to rate changes, the Company performs an earnings simulation analysis and a market value of portfolio equity calculation on a monthly basis.

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

The Company uses seven standard interest rate scenarios in conducting its simulations: stable, upward shocks of 100, 200 and 300 basis points, and downward shocks of 100, 200, and 300 basis points. Our policy is to limit any projected decline in net interest income relative to the stable rate scenario for the next 12 months to less than 5% for a 100 basis point (b.p.) shock, 10% for a 200 b.p. shock, and 15% for a 300 b.p. shock in interest rates. As of September 30, 2010, the Company had the following estimated net interest income sensitivity profile:

| | Immediate Change in Rate | | | | | |
|--------------------------------------|---------------------------------|------------------|------------------|------------------|------------------|------------------|
| | -300 b.p. | -200 b.p. | -100 b.p. | +100 b.p. | +200 b.p. | +300 b.p. |
| Change in Net Int. Inc. (in \$000 s) | -\$ 5,296 | -\$ 3,632 | -\$ 2,025 | -\$ 272 | -\$ 479 | +\$ 1,071 |
| % Change | -9.78% | -6.70% | -3.74% | -0.50% | -0.88% | +1.98% |

Our current interest rate risk profile indicates that a drop in interest rates could have a negative impact on our net interest margin, although we consider the likelihood of further rate decreases to be minimal in the current environment. If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve

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months would likely be \$2.0 million lower, a drop of 3.74% compared to net interest income under a stable rate scenario. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates which are already relatively low (on NOW accounts and savings accounts, for example), and rates on other low-cost interest-bearing liabilities, hit a natural floor of close to zero while variable-rate loan yields continue to drop. This effect is exacerbated by the fact that prepayments on fixed-rate loans tend to increase as rates decline, although as noted previously our model assumptions include a presumed floor for our internal prime rate that partially offsets other negative pressures.

An increase in interest rates could also have an unfavorable effect on net interest income, although if not for the informal floor currently established for our internal prime lending rate our balance sheet would be slightly asset-sensitive, meaning that, all else being equal, net interest income would increase as rates go up. However, because of that floor, our model assumes that if there were an immediate increase of up to 200 basis points in interest rates, the Company's net interest income could be as much as \$479,000 lower than in a flat rate scenario due to the re-pricing lag for many of our variable rate loans. As rates rise further and loan rates lift from their floors, or if management determines that it would not be detrimental to loan volume to raise the informal floor when market interest rates begin to rise, net interest income will benefit.

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

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and management's best estimates. We have found that model results are highly sensitive to changes in the assumed decay rate for non-maturity deposits, in particular. If a higher deposit decay rate is used then changes in EVE worsen, while the slope of the EVE simulations becomes significantly flatter if non-maturity deposits do not run off.

The table below shows estimated changes in the Company's EVE as of September 30, 2010, under different interest rate scenarios relative to a base case of current interest rates:

| | Immediate Change in Rate | | | | | |
|----------------------------|--------------------------|------------|------------|-----------|------------|------------|
| | -300 b.p. | -200 b.p. | -100 b.p. | +100 b.p. | +200 b.p. | +300 b.p. |
| Change in EVE (in \$000 s) | -\$ 11,243 | -\$ 15,175 | -\$ 10,279 | -\$ 2,229 | -\$ 10,595 | -\$ 12,548 |
| % Change | -4.37% | -5.90% | -3.99% | -0.87% | -4.12% | -4.87% |

The table shows that our EVE could deteriorate in both declining and rising rate scenarios. The slope is negative under rising rates due primarily to runoff assumptions for \$652 million in non-maturity deposits, and would be even worse if not for the fact that non-maturity deposit decay rates declined in 2009 and model assumptions were adjusted accordingly. The slope under declining rates has just recently turned negative, due to the acceleration of loan prepayments. Our EVE profile has evolved considerably over the past few years. During 2007 and much of 2008, the addition of fixed-rate loans and a shift into more rate-sensitive funding caused the negative slope in rising rate scenarios to become steeper and the slope in declining rate scenarios to move from negative to positive. In 2009 and 2010, we have been somewhat successful in reversing those trends and reducing the exposure of our economic value of equity to rising rates, due in part to a focus on variable rate loans and longer-maturity funding.

Table of Contents**CAPITAL RESOURCES**

At September 30, 2010, the Company had total shareholders' equity of \$138.5 million, comprised of \$41.6 million in common stock, \$1.4 million in additional paid-in capital, \$92.8 million in retained earnings, and \$2.7 million in accumulated other comprehensive income. Total shareholders' equity at the end of 2009 was \$134.5 million. The \$4.0 million increase in shareholders' equity during the first nine months was due in large part to the addition of \$5.8 million in net earnings, less \$2.1 million in dividends paid. Accumulated other comprehensive income, representing the change in the mark-to-market differential of our investment securities (net of the tax impact), was about even despite the gains taken on investments in the third quarter, and the increase in capital related to stock options was \$349,000.

The Company uses a variety of measures to evaluate its capital adequacy, with risk-based capital ratios calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to ensure that they meet or surpass established internal and external guidelines. The Company and the Bank are both classified as well capitalized, the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. In addition to the minimum leverage ratio required to be classified as well capitalized, noted in the table below, the Bank has informally committed to the FDIC and the DFI that it will maintain a leverage ratio of at least 9%, and the Company has committed to the Federal Reserve Bank of San Francisco (the FRB) to take steps to ensure the Bank's commitment in this regard. Each of the federal regulators has established risk based and leverage capital guidelines for the bank holding companies or banks it regulates, which set total capital requirements and define capital in terms of core capital elements, or Tier 1 capital; and supplemental capital elements, or Tier 2 capital. Tier 1 capital is generally defined as the sum of the core capital elements less goodwill and certain other deductions, notably the unrealized net gains or losses (after tax adjustments) on available-for-sale investment securities carried at fair market value. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) qualified minority interests in consolidated subsidiaries and similar items; and (iv) qualifying trust preferred securities up to a specified limit. All of the \$30 million in junior subordinated debentures on the Company's balance sheet at September 30, 2010 was included in Tier 1 capital, however no assurance can be given that these debentures, which were issued in conjunction with trust preferred securities, will continue to be treated as Tier 1 capital in the future.

Tier 2 capital can include: (i) the allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as Tier 1 capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; (iv) a certain level of unrealized gains on available-for-sale equity securities; and (v) qualifying subordinated debt and redeemable preferred stock (but not more than 50% of Tier 1 capital). Because of the limitation on the allowance for loan and lease losses, only \$12.2 million, or 61%, of our total allowance is currently included in Tier 2 capital. The maximum amount of Tier 2 capital that is allowable for risk-based capital purposes is limited to 100% of Tier 1 capital, net of goodwill. The following table sets forth the Company's and the Bank's regulatory capital ratios as of the dates indicated.

Regulatory Capital Ratios

| (dollars in thousands, unaudited) | September 30, 2010 | December 31, 2009 | Minimum Requirement to be Well Capitalized |
|--|-----------------------|----------------------|--|
| Sierra Bancorp | | | |
| Total Capital to Total Risk-weighted Assets | 17.67% | 16.67% | 10.00% |
| Tier 1 Capital to Total Risk-weighted Assets | 16.41% | 15.41% | 6.00% |
| Tier 1 Leverage Ratio | 12.06% | 11.91% | 5.00% |
| Bank of the Sierra | | | |
| Total Capital to Total Risk-weighted Assets | 17.28% | 16.04% | 10.00% |
| Tier 1 Capital to Total Risk-weighted Assets | 16.02% | 14.78% | 6.00% |
| Tier 1 Leverage Ratio | 11.76% | 11.44% | 5.00% |

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

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PART I FINANCIAL INFORMATION

Item 3

QUALITATIVE & QUANTITATIVE DISCLOSURES

ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosures about market risk is included as part of Part I, Item 2 above. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Market Risk Management .

PART I FINANCIAL INFORMATION

Item 4

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

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

Changes in Internal Controls

There were no significant changes in the Company's internal controls over financial reporting that occurred in the third quarter of 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

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

ITEM 1A: RISK FACTORS

The Risk Factors appearing in the Company's Form 10-K for the fiscal year ended December 31, 2009, as updated or amended by the Company's Form 10-Q for the quarterly period ended June 30, 2010, are hereby amended and restated to read in full as follows:

Risks Relating to our Bank and the Banking Business

Our business has been and may continue to be adversely affected by volatile conditions in the financial markets and deteriorating economic conditions generally. There has been significant disruption and volatility in the financial and capital markets since late 2007. The financial markets and the financial services industry in particular suffered unprecedented disruption, causing a number of institutions to fail or require government intervention to avoid failure. These conditions were largely the result of the erosion of the United States and international credit markets, including a significant and rapid deterioration in the mortgage lending and related real estate markets and valuation levels. Unemployment nationwide and in California has increased significantly through this economic downturn and is anticipated to remain elevated for an extended period. Continued declines in real estate values, high unemployment and financial stress on borrowers as a result of the uncertain economic environment could have an adverse effect on our borrowers or their customers, which could adversely affect our financial condition and results of operations.

As a result of these financial and economic crises, many lending institutions, including our company, have experienced significant declines in the performance of their loans, particularly construction, development and land loans, and unsecured commercial and consumer loans. Our total nonperforming assets increased to \$77.4 million at September 30, 2010, from \$72.6 million at December 31, 2009 and \$37.0 million at December 31, 2008, representing 9.07%, 7.98% and 3.88% of total gross loans and other real estate owned at September 30, 2010, December 31, 2009 and December 31, 2008, respectively. Moreover, competition among depository institutions for quality loans has increased, limiting organic growth opportunities. In addition, the values of the real estate collateral supporting many commercial loans and home mortgages have declined and may continue to decline. Financial institution stock prices have been negatively affected, and the ability of banks and bank holding companies to raise capital or borrow in the debt markets at attractive prices has become more difficult compared to the period preceding the recent financial crisis.

In addition, continued negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increased delinquencies and default rates, which could further increase our charge-offs and provision for loan losses. A worsening of these conditions would likely exacerbate the already adverse impact on us and others in the financial services industry.

The California economy has been particularly hard hit, and the economic decline has been a major factor leading to the significant increase in the Company's nonperforming assets and loan charge-offs. While unemployment levels have always been relatively high in the San Joaquin Valley and in Tulare County, which is our geographic center and the base of our agriculturally oriented communities, the unemployment rate reached 16.9% in July 2010, up from 15.1% in July 2009, and 10.4% in July 2008. The local unemployment rate remained well above the 12.3% aggregate unemployment rate for California as of July 2010. Overall, the general business environment and local market conditions have had an adverse effect on our business during the past year, and there can be no assurance that the environment will improve in the near term. Until conditions improve, it is expected that our business, financial condition and results of operations will be adversely affected.

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The current challenges facing the agricultural industry could have an adverse effect on our customers and their ability to make payments to us. While the current high level of the Company's nonperforming assets is comprised mainly of other real estate owned and loans secured by land, lots, and residential real estate, high levels of nonperforming assets historically have been the direct consequence of persistent difficulties facing the agricultural industry in our market areas. This is due to the fact that a sizable portion of our total loan portfolio consists of loans to borrowers either directly or indirectly involved in the agricultural industry. A great number of our borrowers may not be individually directly involved in agriculture, but many of the jobs in the San Joaquin Valley are ancillary to the regular production, processing, marketing and sales of agricultural commodities.

The entry of global suppliers into the market has, in the past, led to excess market supply of many agricultural products, and a drop in consumer demand is currently contributing to softness in the market. Because of increased supply from overseas competition, declining demand and other factors, low prices currently characterize the markets for many agricultural products. The ripple effect of lower commodity prices for milk, nuts, olives, grapes, oranges and tree fruit has a tendency to depress land prices, lower borrower income, and decrease collateral values. Weather patterns are also of critical importance to row crop, tree fruit, and orange production. A degenerative cycle of weather has the potential to adversely affect agricultural industries as well as consumer purchasing power, and could lead to further unemployment throughout the San Joaquin Valley. Another potential looming issue that could have a major impact on the agricultural industry involves water distribution rights. If the amount of water available to agriculture becomes increasingly scarce due to drought and/or diversion to other uses, farmers may not be able to continue to produce agricultural products at a reasonable profit, which has the potential to force many out of business. Such conditions have affected and may continue to adversely affect our borrowers and, by extension, our business, and if general agricultural conditions decline further our level of nonperforming assets could increase.

Concentrations of real estate loans could subject us to increased risks in the event of a prolonged real estate recession or natural disaster. Our loan portfolio is heavily concentrated in real estate loans, particularly commercial real estate. At September 30, 2010, 77% of our loan portfolio consisted of loans secured by real estate. Balances secured by commercial properties and construction and development loans represented 60% of all real estate loans, while loans secured by non construction residential properties accounted for 30%, and loans secured by farmland were approximately 10% of real estate loans.

The Company's \$77.4 million balance of nonperforming assets at September 30, 2010 included \$25.9 million in foreclosed assets, primarily other real estate owned (OREO) consisting of vacant land, lots, and residential properties. Nonperforming loans totaling \$51.5 million comprised the remainder of the nonperforming assets, and \$44.2 million of that balance was in nonperforming real estate loans. The largest block of nonperforming real estate loans was \$25.3 million in commercial real estate loans, although nonperforming construction and development loans also totaled \$14.4 million.

The Central Valley residential real estate market experienced significant deflation in property values during 2008 and the first half of 2009, and foreclosures have continued to occur at relatively high rates since the beginning of the recession. If residential real estate values slide further, and/or if this weakness further impacts commercial real estate values, the Company's nonperforming assets could further increase from current levels. Such an increase could have a material adverse effect on our financial condition and results of operations by reducing our income, increasing our expenses, and leaving less cash available for lending and other activities. As noted above, the primary collateral for many of our loans consists of commercial real estate properties, and continued deterioration in the real estate market in the areas the Company serves would likely reduce the value of the collateral value for many of our loans and could negatively impact the repayment ability of many of our borrowers. It might also reduce further the amount of loans the Company makes to businesses in the construction and real estate industry, which could negatively impact our organic growth prospects. Similarly, the occurrence of a natural disaster like those California has experienced in the past, including earthquakes, brush fires, and flooding, could impair the value of the collateral we hold for real estate secured loans and negatively impact our results of operations.

In addition, banking regulators now give commercial real estate loans extremely close scrutiny, due to risks relating to the cyclical nature of the real estate market and related risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of CRE loans to implement enhanced underwriting standards, internal controls, risk management policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Expectations for higher capital levels have also materialized. Any increase in our allowance for loan losses would adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact financial performance measures such as earnings per share.

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Our concentrations of commercial real estate, construction and land development and commercial, industrial loans expose us to increased lending risks. Commercial real estate, construction and land development, and commercial and industrial loans and leases, not including SBA loans, comprised approximately 58% of our total loan portfolio as of September 30, 2010, and expose the Company to a greater risk of loss than residential real estate and consumer loans, which comprised a smaller percentage of the total loan portfolio. Commercial real estate and land development loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential loans. Consequently, an adverse development with respect to one commercial loan or one credit relationship exposes us to a significantly greater risk of loss compared to an adverse development with respect to one residential mortgage loan.

Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. At September 30, 2010, we had \$122 million or 14.7% of total loans in commercial loans and leases, including agricultural production loans but not including SBA loans. Commercial lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial loans depends primarily on the cash flow and credit worthiness of the borrower and secondarily on the underlying collateral provided by the borrower.

Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition. Our nonperforming assets adversely affect our net income in various ways. Until economic and market conditions improve, we expect that our level of nonperforming loans will continue to impact our earnings, and could have a substantial adverse impact if conditions deteriorate further. We do not record interest income on non-accrual loans, thereby adversely affecting our level of interest income. Additionally, our non interest expense has increased due to the costs of reappraising adversely classified assets, legal and other costs associated with loan collections, operating costs related to foreclosed assets, and various other expenses that would not typically be incurred in a normal operating environment. Furthermore, when we receive collateral through foreclosures and similar proceedings, we are required to mark the related loan to the then fair market value of the collateral less estimated selling costs, which may result in a loss. An increase in the level of nonperforming assets also increases our risk profile and may impact the capital levels our regulators believe is appropriate in light of such risks. We utilize various techniques such as loan sales, workouts and restructurings to manage our problem assets. Decreases in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires a significant commitment of time from management and staff, which can be detrimental to performance of their other responsibilities. There can be no assurance that we will avoid further increases in nonperforming loans in the future.

We may experience loan and lease losses in excess of our allowance for loan and lease losses. We are careful in our loan underwriting process in order to limit the risk that borrowers might fail to repay; nevertheless, losses can and do occur. We maintain an allowance for estimated loan and lease losses in our accounting records, based on estimates of the following:

industry standards;

historical experience with our loans;

evaluation of economic conditions;

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regular reviews of the quality mix and size of the overall loan portfolio;

a detailed cash flow analysis for nonperforming loans;

regular reviews of delinquencies; and

the quality of the collateral underlying our loans.

We maintain an allowance for loan and lease losses at a level that we believe is adequate to absorb specifically identified probable losses as well as any other losses inherent in our loan portfolio at a given date. While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any time there are loans in the portfolio that could result in losses, but that have not been identified as nonperforming or potential problem loans. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that have been identified. Changes in economic, operating and other conditions, including changes in interest rates, deteriorating values in underlying collateral (most of which consists of real estate), and the financial condition of borrowers, which are beyond our control, may cause our estimate of probable losses or actual loan losses to exceed our current allowance. In addition, the FDIC and the DFI, as part of their supervisory functions, periodically review our allowance for loan and lease losses. Such agencies may require us to increase our provision for loan and lease losses or to recognize further losses, based on their judgments, which may be different from those of our management. If our actual losses exceed the amount currently reserved, or if the FDIC or the DFI required us to increase the allowance, additional provisions to the allowance would be necessary which could have a material adverse effect on our profitability and capital levels.

Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the real property collateral. In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is made. If the appraisal does not reflect the amount that may be obtained upon any sale or foreclosure of the property, we may not realize an amount equal to the indebtedness secured by the property in the event of foreclosure.

We have informally agreed with our regulatory agencies to certain restrictions and/or notification requirements which could affect our ability to pay dividends and which require us to maintain a leverage capital ratio level which is higher than that required by standard regulations. The Bank has informally agreed with the FDIC and the DFI to (i) obtain the prior written consent of both agencies prior to paying any cash dividends to the Company, (ii) maintain a leverage capital ratio of at least 9%, (iii) notify the FDIC and the DFI prior to making any changes in the Bank's senior management or Board of Directors, and (iv) develop an action plan to systematically reduce adversely classified assets. The Company has informally agreed with the Federal Reserve Bank of San Francisco (the "FRB") to (i) take steps to ensure the Bank's commitments listed above; (ii) notify the FRB prior to paying any dividends on our common stock, receiving dividends from the Bank, or making payments related to our subordinated debentures or trust preferred securities; and (iii) obtain the written approval of the FRB prior to incurring any new or increased debt or repurchasing shares of our common stock. We believe that the Bank and the Company are currently in substantial compliance with these informal agreements, although formal determinations of compliance can only be made by the regulatory authorities. If the regulatory authorities should subsequently determine that we are not in compliance, they could take additional action such as the issuance of a formal enforcement order.

Our expenses have increased and could continue to increase as a result of higher FDIC insurance premiums. The FDIC, absent extraordinary circumstances, must establish and implement a plan to restore the deposit insurance reserve ratio to 1.35% of estimated insured deposits or the comparable percentage of the assessment base at any time that the reserve ratio falls below 1.35%. Recent bank failures have depleted the deposit insurance fund balance, which has been in a negative position since the end of 2009, and the FDIC currently has until September 30, 2020 to bring the reserve ratio back to the statutory minimum. The FDIC has stated that it expects insured institution failures to peak in 2010, which will result in continued charges against the Deposit Insurance Fund, and they have implemented a restoration plan that changes both its risk-based assessment system and its base assessment rates. As part of this plan, the FDIC adopted a final rule revising its risk-based assessment system, effective April 1, 2009. The changes to the assessment system involve adjustments to the risk-based calculation of an institution's unsecured debt, secured liabilities and brokered deposits. The FDIC also imposed a special assessment in 2009 and required the prepayment of three years of FDIC insurance premiums at the end of 2009. The prepayments are designed to help address liquidity issues created by potential timing differences between the collection of premiums and charges against the DIF, but it is generally expected that assessment rates will continue to increase in the near term due to the significant cost of bank failures and the relatively large number of troubled

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banks. In addition, as with many institutions, our FDIC deposit insurance premiums have increased since the beginning of the recession due to the relative condition of the Bank. Any further significant premium increases or special assessments could have a material adverse effect on our financial condition and results of operations.

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We may not be able to continue to attract and retain banking customers, and our efforts to compete may reduce our profitability.

Competition in the banking industry in the markets we serve may limit our ability to continue to attract and retain banking customers. The banking business in our current and intended future market areas is highly competitive with respect to virtually all products and services. In California generally, and in our service areas specifically, branches of major banks dominate the commercial banking industry. Such banks have substantially greater lending limits than we have, offer certain services we cannot offer directly, and often operate with economies of scale that result in lower operating costs than ours on a per loan or per asset basis. We also compete with numerous financial and quasi-financial institutions for deposits and loans, including providers of financial services over the Internet. Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

In addition, with the increase in bank failures, customers increasingly are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with their bank is fully insured. Decreases in deposits may adversely affect our funding costs and net income. Ultimately, competition can and does increase our cost of funds, reduce loan yields and drive down our net interest margin, thereby reducing profitability. It can also make it more difficult for us to continue to increase the size of our loan portfolio and deposit base, and could cause us to rely more heavily on wholesale borrowings, which are generally more expensive than deposits.

If we are not able to successfully keep pace with technological changes affecting the industry, our business could be hurt. The financial services industry is constantly undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better service clients and reduce costs. Our future success depends, in part, upon our ability to address the needs of our clients by using technology to provide products and services that will satisfy client demands, as well as create additional efficiencies within our operations. Some of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our clients. Failure to successfully keep pace with technological change in the financial services industry could have a material adverse impact on our business and, in turn, on our financial condition and results of operations.

If our information systems were to experience a system failure or a breach in security, our business and reputation could suffer. We rely heavily on communications and information systems to conduct our business. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. In addition, we must be able to protect our computer systems and network infrastructure against physical damage, security breaches and service disruption caused by the Internet or other users. Such computer break-ins and other disruptions would jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure. We have protective measures in place to prevent or limit the effect of the failure, interruption or security breach of our information systems and will continue to implement security technology and monitor and update operational procedures to prevent such damage. However, if such failures, interruptions or security breaches were to occur, they could result in damage to our reputation, a loss of customer business, increased regulatory scrutiny, or possible exposure to financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

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We are subject to a variety of operational risks, including reputational risk, legal risk and compliance risk, and the risk of fraud or theft by employees or outsiders, which may adversely affect our business and results of operations.

We are exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems.

If personal, non-public, confidential or proprietary information of customers in our possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include, for example, if such information were erroneously provided to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets) which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that we (or our vendors) business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could result in a diminished ability of us to operate our business (for example, by requiring us to expend significant resources to correct the defect), as well as potential liability to clients, reputational damage and regulatory intervention, which could adversely affect our business, financial condition and results of operations, perhaps materially.

Recently enacted and potential further financial regulatory reforms could have a significant impact on our business, financial condition and results of operations. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law. The Dodd-Frank Act is expected to have a broad impact on the financial services industry, including significant regulatory and compliance changes. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of business activities, require changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. In particular, the potential impact of the Dodd-Frank Act on our operations and activities, both currently and prospectively, include, among others:

a reduction in the ability to generate or originate revenue-producing assets as a result of compliance with heightened capital standards;

increased cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, and higher deposit insurance premiums;

the limitation on the ability to raise new capital through the use of trust preferred securities, as any new issuances of these securities will no longer be included as Tier 1 capital going forward;

a potential reduction in fee income due to limits on interchange fees applicable to larger institutions which could effectively reduce the fees we can charge; and

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the limitation on the ability to expand consumer product and service offerings due to anticipated stricter consumer protection laws and regulations.

Further, we may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act, which may negatively impact results of operations and financial condition.

Additionally, we cannot predict whether there will be additional proposed laws or reforms that would affect the U.S. financial system or financial institutions, whether or when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

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We may be adversely affected by the soundness of other financial institutions. Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. In addition, our credit risk may be exacerbated when collateral held by us cannot be liquidated at prices sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could adversely affect our business, financial condition or results of operations.

Our earnings are subject to interest rate risk. Banking companies' earnings depend largely on the relationship between the cost of funds, primarily deposits and borrowings, and the yield on earning assets, such as loans and investment securities. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by the monetary policies of the Federal Reserve Board and the international interest rate environment, as well as by economic, regulatory and competitive factors which influence interest rates, the volume and mix of interest earning assets and interest bearing liabilities, and the level of nonperforming assets. Many of these factors are beyond our control. We are subject to interest rate risk to the degree that our interest bearing liabilities re-price or mature more slowly or more rapidly or on a different basis than our interest earning assets. Fluctuations in interest rates also affect the demand of customers for our products and services.

We depend on our executive officers and key personnel to implement our business strategy and could be harmed by the loss of their services. We believe that our continued growth and success depends in large part upon the skills of our management team and other key personnel. The competition for qualified personnel in the financial services industry is intense, and the loss of key personnel or an inability to continue to attract, retain or motivate key personnel could adversely affect our business. If we are not able to retain our existing key personnel or attract additional qualified personnel, our business operations would be hurt. None of our executive officers have employment agreements.

The value of securities in our investment securities portfolio may be negatively affected by continued disruptions in securities markets. The market for some of the investment securities held in our portfolio has been experiencing volatility and disruption for the last several years. These market conditions have affected and may further adversely affect the value of these securities, such as through reduced valuations because of the perception of heightened credit and liquidity risks. There can be no assurance that the declines in market value associated with these disruptions will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our results of operations and capital levels.

We are exposed to risk of environmental liabilities with respect to properties to which we obtain title. Approximately 77% of our loan portfolio at September 30, 2010 was secured by real estate. In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. These costs and claims could adversely affect our business and prospects.

Risks Related to our Common Stock

The price of our common stock may fluctuate significantly, and this may make it difficult for you to sell shares of common stock at times or at prices you find attractive. The trading price of the shares of our common stock and the value of our other securities will depend on many factors which may change from time to time, including, without limitation, our financial condition, performance, creditworthiness and prospects, future sales of our equity or equity related securities, and other factors identified

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elsewhere in this Risk Factors section. In addition, the stock market is subject to broad fluctuations that affect the market prices of the shares of many companies, including ours. Many of these factors are beyond our control. Among the factors that could affect our common stock price in the future are:

actual or anticipated quarterly fluctuations in our operating results and financial condition;

formal regulatory action against us;

changes in revenue or earnings estimates or publication of research reports and recommendations by financial analysts;

failure to meet analysts' revenue or earnings estimates;

speculation in the press or investment community;

strategic actions by us or our competitors, such as acquisitions or restructurings;

acquisitions of other banks or financial institutions, through FDIC-assisted transactions or otherwise;

actions by shareholders;

fluctuations in the stock price, trading volumes, and operating results of our competitors;

general market conditions and, in particular, developments related to the financial services industry;

proposed or adopted regulatory changes or developments;

anticipated or pending investigations, proceedings, or litigation that involve or affect us; and

domestic and international economic factors unrelated to our performance.

The stock market and, in particular, the market for financial institution stocks, has experienced significant volatility. As a result, the market price of our common stock may be volatile. In addition, the trading volume in our common stock may fluctuate more than usual with significant price variations occurring. The capital and credit markets have been experiencing volatility and disruption for several years, at times reaching unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. A significant decline in our stock price could result in substantial losses for individual shareholders and could lead to costly and disruptive securities litigation.

We may pursue additional capital in the future, which may not be available on acceptable terms or at all, could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock. In the current economic environment, we

believe it is prudent to consider alternatives for raising capital when opportunities to raise capital at attractive prices present themselves, in order to further strengthen our capital and better position ourselves to take advantage of opportunities that may arise in the future. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at the time, which are outside of our control, and our financial performance. We cannot assure you that such capital will be available to us on acceptable terms or at all. Any such capital raising alternatives could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock and our performance measures such as earnings per share.

The Company relies heavily on the payment of dividends from the Bank. Other than \$9.6 million in cash available at the holding company level at November 1, 2010, our ability to meet debt service requirements and to pay dividends depends on the Bank's ability to pay dividends to us, as we have no other source of significant income. However, the Bank is subject to regulations limiting the amount of dividends it may pay to us. For example, the payment of dividends by the Bank is affected by the requirement to maintain adequate capital pursuant to the capital adequacy guidelines issued by the Federal Deposit Insurance Corporation. All banks and bank holding companies are required to maintain a minimum ratio of qualifying total capital to total risk-weighted assets of 8.0%, at least one-half of which must be in the form of Tier 1 capital, and a ratio of Tier 1 capital to average adjusted assets of 4.0% and the Bank has informally agreed with the FDIC and the DFI to maintain a leverage capital ratio of at least 9%. If (i) any of these required ratios are increased; (ii) the total of risk-weighted assets of the Bank increases significantly; and/or (iii) the Bank's income decreases significantly, the Bank's Board of Directors may decide or be required to retain a greater portion of the Bank's earnings to achieve and maintain the required capital or asset ratios. This will reduce the amount of funds available for the payment of dividends by the Bank to us. The Bank has also informally committed to the FDIC and the DFI that it will obtain the prior written consent of both agencies prior to paying any cash dividends, although the Company believes it has sufficient cash on hand to cover anticipated

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expenses and dividend payments to shareholders through the end of 2011 without supplemental dividends from the Bank. Further, in some cases, the Federal Reserve Board could take the position that it has the power to prohibit the Bank from paying dividends if, in its view, such payments would constitute unsafe or unsound banking practices. The Bank's ability to pay dividends to us is also limited by the California Financial Code. Whether dividends are paid and their frequency and amount will also depend on the financial condition and performance, and the discretion of the Board of Directors of the Bank. Information concerning the Company's dividend policy and historical dividend practices is set forth below under Dividend Policy. However, no assurance can be given that our future performance will justify the payment of dividends in any particular year.

You may not be able to sell your shares at the times and in the amounts you want if the trading market for our stock is not active.

Although our stock has been listed on NASDAQ for many years, trading in our stock does not consistently occur in high volumes and cannot be characterized as amounting to an active trading market. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market of our common stock. Future sales of substantial amounts of common stock in the public market, or the perception that such sales may occur, could adversely affect the prevailing market price of the common stock.

Your investment may be diluted because of the ability of management to offer stock to others and stock options. The shares of our common stock do not have preemptive rights. This means that you may not be entitled to buy additional shares if shares are offered to others in the future. We are authorized to issue 24,000,000 shares of common stock, and as of November 1, 2010 we had 13,976,741 shares of our common stock outstanding. Except as described in Plan of Distribution and certain limitations imposed by NASDAQ, nothing restricts management's ability to offer additional shares of stock for fair value to others in the future. The market price of our common stock could decline as a result of sales by us of a large number of shares of common stock or preferred stock or similar securities in the market, or from the perception that such sales could occur. Further, any issuances of common stock would dilute our shareholders' ownership interests and may dilute the per share book value of our common stock. In addition, when our directors, executive officers and key employees exercise any of their stock options, your ownership in the Company will be diluted. As of September 30, 2010, there were outstanding options to purchase an aggregate of 658,708 shares of our common stock with an average exercise price of \$15.20 per share. At the same date there were an additional 1,201,400 shares available for grant under our 2007 Stock Incentive Plan.

Shares of our preferred stock issued in the future could have dilutive and other effects. Shares of our preferred stock eligible for future issuance and sale could have a dilutive effect on the market for shares of our common stock. Our Articles of Incorporation authorize us to issue 10,000,000 shares of preferred stock, none of which is presently outstanding. Although our Board of Directors has no present intent to authorize the issuance of shares of preferred stock, such shares could be authorized in the future. If such shares of preferred stock are made convertible into shares of common stock, there could be a dilutive effect on the shares of common stock then outstanding. In addition, shares of preferred stock may be provided a preference over holders of common stock upon our liquidation or with respect to the payment of dividends, in respect of voting rights or in the redemption of our common stock. The rights, preferences, privileges and restrictions applicable to any series or preferred stock would be determined by resolution of our Board of Directors.

The holders of our debentures have rights that are senior to those of our shareholders. In 2004 we issued \$15,464,000 of junior subordinated debt securities due March 17, 2034 and in 2006 we issued an additional \$15,464,000 of junior subordinated debt securities due September 23, 2036 in order to raise additional regulatory capital. These junior subordinated debt securities are senior to the shares of our common stock. As a result, we must make interest payments on the debentures before any dividends can be paid on our common stock, and in the event of our bankruptcy, dissolution or liquidation, the holders of the debt securities must be paid in full before any distributions may be made to the holders of our common stock. In addition, we have the right to defer interest payments on the junior subordinated debt securities for up to five years, during which time no dividends may be paid to holders of our common stock. In the event that the Bank is unable to pay dividends to us, then we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and, thus, we would be unable to declare and pay any dividends on our common stock.

Our directors and executive officers control a large amount of our stock, and your interests may not always be the same as those of the board and management. As of September 30, 2010, our directors and executive officers together with their affiliates

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beneficially owned approximately 17% of the Company's outstanding voting stock (not including vested option shares). As a result, if all of these shareholders were to take a common position, they might be able to affect the election of directors as well as the outcome of corporate actions requiring shareholder approval, such as the approval of mergers or other business combinations. Such concentration may also have the effect of delaying or preventing a change in control of our company. In some situations, the interests of our directors and executive officers may be different from the shareholders. However, our directors and executive officers have a fiduciary duty to act in the best interest of the shareholders, rather than in their own best interests, when considering a proposed business combination or any of these types of matters.

Provisions in our articles of incorporation could delay or prevent changes in control of our corporation or our management. Our articles of incorporation contain provisions for staggered terms of office for members of the board of directors; no cumulative voting in the election of directors; and the requirement that our board of directors consider the potential social and economic effects on our employees, depositors, customers and the communities we serve as well as certain other factors, when evaluating a possible tender offer, merger or other acquisition of the Company. These provisions make it more difficult for another company to acquire us, which could cause our shareholders to lose an opportunity to be paid a premium for their shares in an acquisition transaction, and reduce the current and future market price of our common stock.

ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**(c) Stock Repurchases**

The following table provides information concerning the Company's repurchases of its Common Stock during the third quarter of 2010:

| | July | August | September |
|--|---------|---------|-----------|
| Total shares purchased | 0 | 0 | 0 |
| Average per share price | N/A | N/A | N/A |
| Number of shares purchased as part of | | | |
| publicly announced plan or program | N/A | N/A | N/A |
| Maximum number of shares remaining for purchase under a plan or program ⁽¹⁾ | 100,669 | 100,669 | 100,669 |

- (1) The current stock repurchase plan became effective July 1, 2003 and has no expiration date. The repurchase program initially provided that up to 250,000 shares of Sierra Bancorp's common stock could be purchased by the Company from time to time. That amount was supplemented by 250,000 shares on May 19, 2005, another 250,000 shares on March 16, 2006, and an additional 500,000 shares on April 19, 2007. Any future purchases pursuant to this program will require the prior written approval of the FRB.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4: (REMOVED AND RESERVED)**ITEM 5: OTHER INFORMATION**

Not applicable

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ITEM 6 : EXHIBITS

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

- (1) Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.
- (2) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.
- (3) Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission (SEC) (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.
- (4) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.
- (5) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.
- (6) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.
- (7) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
- (8) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.

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- (9) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
- (10) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
- (11) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.

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SIGNATURES

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

November 8, 2010
Date

/s/ James C. Holly
SIERRA BANCORP

James C. Holly
President &
Chief Executive Officer

November 8, 2010
Date

/s/ Kenneth R. Taylor
SIERRA BANCORP

Kenneth R. Taylor
Chief Financial Officer &
Chief Accounting Officer