SIERRA BANCORP
Form 10-Q
May 07, 2018
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2018

Commission file number: 000-33063

Sierra Bancorp

(Exact name of Registrant as specified in its charter)

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

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant’s telephone number, including area code)

Not Applicable

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

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

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

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

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

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

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

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

Common stock, no par value, 15,255,100 shares outstanding as of May 1, 2018

FORM 10-Q

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1 – Financial Statements

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

ASSETS	March 31, 2018 (unaudited)	December 31, 2017 (audited)
Cash and due from banks	$56,221	$61,142
Interest-bearing deposits in banks	7,288	8,995
Total cash & cash equivalents	63,509	70,137
Securities available-for-sale	563,582	558,329
Loans and leases:		
Gross loans and leases	1,592,216	1,557,820
Allowance for loan and lease losses	(8,991)	(9,043)
Deferred loan and lease costs, net	2,953	2,774
Net loans and leases	1,586,178	1,551,551
Foreclosed assets	5,371	5,481
Premises and equipment, net	29,060	29,388
Goodwill	27,357	27,357
Other intangible assets, net	6,004	6,234
Company owned life insurance	47,590	47,108
Other assets	44,873	44,713
Total assets	$2,373,524	$2,340,298
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$642,363	$635,434
Interest bearing	1,394,267	1,352,952
Total deposits	2,036,630	1,988,386
Repurchase agreements	12,529	8,150
Federal funds purchased	300	—
Short-term borrowings	5,800	21,900
Subordinated debentures, net	34,633	34,588
Other liabilities	28,312	31,332
Total liabilities	2,118,204	2,084,356
Commitments and contingent liabilities (Note 8)		
Shareholders' equity		
Common stock, no par value; 24,000,000 shares authorized; 15,246,780 and 15,223,360 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively	111,599	111,138
Additional paid-in capital	2,929	2,937
Retained earnings	148,469	144,197

Accumulated other comprehensive loss, net	(7,677)	(2,330)
Total shareholders' equity	255,320	255,942
Total liabilities and shareholder's equity	$2,373,524	$2,340,298

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

1

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

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

	Three months ended March 31,	
Interest and dividend income	2018	2017
Loans and leases, including fees	$20,004	$14,970
Taxable securities	2,338	2,008
Tax-exempt securities	1,016	805
Federal funds sold and other	118	119
Total interest income	23,476	17,902
Interest expense		
Deposits	1,318	689
Short-term borrowings	13	10
Subordinated debentures	385	320
Total interest expense	1,716	1,019
Net interest income	21,760	16,883
Provision for loan losses	200	—
Net interest income after provision for loan losses	21,560	16,883
Non-interest income		
Service charges on deposits	2,946	2,571
Net gains on sale of securities available-for-sale	—	8
Other income	2,187	2,554
Total non-interest income	5,133	5,133
Other operating expense		
Salaries and employee benefits	9,183	7,885
Occupancy and equipment	2,348	2,320
Other	6,356	5,496
Total other operating expense	17,887	15,701
Income before taxes	8,806	6,315
Provision for income taxes	2,096	1,764
Net income	$6,710	$4,551
PER SHARE DATA		
Book value	$16.75	$15.21
Cash dividends	$0.16	$0.14
Earnings per share basic	$0.44	$0.33
Earnings per share diluted	$0.44	$0.32
Average shares outstanding, basic	15,232,696	13,801,635
Average shares outstanding, diluted	15,412,168	14,009,496
Total shareholder equity (in thousands)	$255,320	$210,417
Shares outstanding	15,246,780	13,829,649
Dividends paid (in thousands)	$2,437	$1,931

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands, unaudited)

	Three months ended March 31, 2018	2017
Net income	$6,710	$4,551
Other comprehensive income, before tax:		
Unrealized (losses) gains on securities:		
Unrealized holding (loss) gain arising during period	(7,592)	1,410
Less: reclassification adjustment for gains included in net income [1]	—	(8)
Other comprehensive (loss) income, before tax	(7,592)	1,402
Income tax expense related to items of other comprehensive income (loss), net of tax	2,245	(590)
Other comprehensive (loss) income	(5,347)	812
Comprehensive income	$1,363	$5,363

[1] Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended March 31, 2018 and 2017 was $0 thousand and $3 thousand respectively.

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Three months ended March 31,	
	2018	2017
Cash flows from operating activities:		
Net income	$6,710	$4,551
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of securities	—	(8)
Loss on disposal of fixed assets	—	3
Gain on sale on foreclosed assets	—	(13)
Writedowns on foreclosed assets	110	98
Share-based compensation expense	76	423
Provision for loan losses	200	—
Depreciation and amortization	785	719
Net amortization on securities premiums and discounts	1,423	1,758
Accretion of discounts for loans acquired	(356)	(298)
Increase in cash surrender value of life insurance policies	(204)	(452)
Amortization of core deposit intangible	230	107
Decrease in interest receivable and other assets	2,633	226
(Decrease) increase in other liabilities	(3,020)	982
Deferred income tax benefit	(953)	(111)
Net amortization of partnership investment	405	—
Net cash provided by operating activities	8,039	7,985
Cash flows from investing activities:		
Proceeds from sales/calls of securities available for sale	200	12,905
Purchases of securities available for sale	(36,750)	(59,511)
Principal pay downs on securities available for sale	22,282	25,086
Loan originations and payments, net	(34,471)	26,817
Purchases of premises and equipment, net	(412)	(803)
Proceeds from sales of foreclosed assets	—	29
Purchase of company owned life insurance	(278)	(221)
Net cash from bank acquisition	(6)	—
Net cash (used in) provided by investing activities	(49,435)	4,302
Cash flows from financing activities:		
Increase in deposits	48,244	24,950
Decrease in borrowed funds	(16,100)	(65,000)
Increase in Fed funds purchased	300	—
Increase in repurchase agreements	4,379	1,337
Cash dividends paid	(2,437)	(1,931)
Stock options exercised	382	683
Net cash provided by (used in) financing activities	34,768	(39,961)

Decrease in cash and due from banks	(6,628)	(27,674)
Cash and cash equivalents		
Beginning of period	70,137	120,442
End of period	$63,509	$92,768

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

Sierra Bancorp

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2018

(Unaudited)

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of March 31, 2018, the Company's only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which were formed solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). Pursuant to the Financial Accounting Standards Board ("FASB") standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the Company's financial statements. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

Bank of the Sierra, a California state-chartered bank headquartered in Porterville, California, offers a full range of retail and commercial banking services via branch offices located throughout California's South San Joaquin Valley, the Central Coast, Ventura County, and neighboring communities. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with $1.5 million in capital. Our growth in the ensuing years has largely been organic in nature, but includes four whole-bank acquisitions: Sierra National Bank in 2000, Santa Clara Valley Bank in 2014, Coast National Bank in 2016, and Ojai Community Bank in October 2017. We plan to open a new branch on Palm Avenue in Fresno in mid-2018, and have an agreement with Community Bank of Santa Maria to acquire its branch located in Lompoc, California in the second quarter of 2018. Lompoc branch deposits totaled almost $40 million at March 31, 2018, consisting largely of non-maturity deposits. As of the filing date of this report the Bank operates 39 full service branches and an online branch, and maintains ATMs at all branch locations and seven non-branch locations. Details on our most recent acquisitions and planned branch purchase are provided in Note 13 to the financial statements, Recent Developments. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. We were close to $2.4 billion in total assets as of March 31, 2018, and for the past several years have claimed the distinction of being the largest bank headquartered in the South San Joaquin Valley. The Bank's deposit accounts, which totaled over $2.0 billion at March 31, 2018, are insured by the Federal Deposit Insurance Corporation ("FDIC") up to maximum insurable amounts.

Note 2 – Basis of Presentation

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

Note 3 – Current Accounting Developments

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

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

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

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

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

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

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

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

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

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

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

Note 4 – Supplemental Disclosure of Cash Flow Information

During the three months ended March 31, 2018 and 2017, cash paid for interest due on interest-bearing liabilities was $1.874 million and $1.070 million, respectively. There was no cash paid for income taxes during the three months ended March 31, 2018 or 2017. There were no assets acquired in settlement of loans for the three months ended March 31, 2018, relative to $94,000 during the three months ended March 31, 2017. We received no cash from the sale of foreclosed assets during the first three months of 2018 relative to $29,000 during the first three months of 2017, which represents sales proceeds less loans (if any) extended to finance such sales.

Note 5 – Share Based Compensation

On March 16, 2017 the Company's Board of Directors approved and adopted the 2017 Stock Incentive Plan (the "2017 Plan"), which became effective May 24, 2017, the date approved by the Company's shareholders. The 2017 Plan replaced the Company's 2007 Stock Incentive Plan (the "2007 Plan"), which expired by its own terms on March 15, 2017. Options to purchase 424,300 shares that were granted under the 2007 Plan were still outstanding as of March 31, 2018, and remain unaffected by that plan's expiration. The 2017 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors and consultants of the Company. The 2017 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, although no restricted stock awards have ever been issued by the Company. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2017 Plan was initially 850,000 shares, and the number remaining available for grant as of March 31, 2018 was 766,000. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share.

Pursuant to FASB's standards on stock compensation, the value of each stock option granted is reflected in our income statement as employee compensation or directors' expense by expensing its fair value as of the grant date in the case of immediately vested options, or by amortizing its grant date fair value over the vesting period for options with graded vesting. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee's options for each vesting period are separately valued and amortized. A pre-tax charge of $76,000 was reflected in the Company's income statement during the first quarter of 2018 and $423,000 was charged during the first quarter of 2017, as expense related to stock options.

Note 6 – Earnings per Share

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 15,232,696 weighted average shares outstanding during the first quarter of 2018, and 13,801,635 during the first quarter of 2017.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of “in-the-money” stock options. For the first quarter of 2018, calculations under the treasury stock method resulted in the equivalent of 179,472 shares being added to basic weighted average shares outstanding for purposes of determining diluted earnings per share, while a weighted average of 169,000 stock options were excluded from the calculation because they were underwater and thus anti-dilutive. For the first quarter of 2017 the equivalent of 207,861 shares were added in calculating diluted earnings per share, while 90,000 anti-dilutive stock options were not factored into the computation.

Note 7 – Comprehensive Income

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

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

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

	March 31, 2018	December 31, 2017
Commitments to extend credit	$686,472	$691,712
Standby letters of credit	$9,992	$9,168

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

At March 31, 2018, the Company was also utilizing a letter of credit in the amount of $86 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

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

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

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

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

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

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

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

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

	March 31, 2018				
		Fair Value Measurements			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$63,509	$63,507	$—	$ —	$63,507
Investment securities available for sale	563,582	—	563,582	—	563,582
Loans and leases, net held for investment	1,585,880	—	1,559,992	—	1,559,992
Collateral dependent impaired loans	298	—	298	—	298
Cash surrender value of life insurance policies	47,590	—	47,590	—	47,590
Financial liabilities:					
Deposits	2,036,630	642,363	1,393,754	—	2,036,117
Subordinated debentures	34,633	—	24,377	—	24,377

	December 31, 2017				
		Fair Value Measurements			
	Carrying Amount	Quoted Prices Active Markets for	Significant Observable	Significant Unobservable	Total

		Identical Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)	
Financial assets:					
Cash and cash equivalents	$70,137	$70,141	$—	$ —	$70,141
Investment securities available for sale	558,329	—	558,329	—	558,329
Loans and leases, net held for investment	1,551,174	—	1,563,765	—	1,563,765
Collateral dependent impaired loans	377	—	377	—	377
Cash surrender value of life insurance policies	47,108	—	47,108	—	47,108
Financial liabilities:					
Deposits	1,988,386	635,434	1,352,740	—	1,988,174
Subordinated debentures	34,588	—	24,216	—	24,216

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

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

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

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

	Fair Value Measurements at March 31, 2018, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss) (Level 3)
Securities:					
US Government agencies	$—	$ 19,725	$ —	$ 19,725	$ —
Mortgage-backed securities	—	401,984	—	401,984	—
State and political subdivisions	—	141,873	—	141,873	—
Total available-for-sale securities	$—	$ 563,582	$ —	$ 563,582	$ —

Fair Value Measurements at December 31, 2017, using

Quoted Prices in Active Markets for | Significant | Significant | Total | Realized

	Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)		Gain/(Loss) (Level 3)
Securities:					
US Government agencies	$—	$ 21,326	$ —	$ 21,326	$ —
Mortgage-backed securities	—	393,802	—	393,802	—
State and political subdivisions	—	143,201	—	143,201	—
Total available-for-sale securities	$—	$ 558,329	$ —	$ 558,329	$ —

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

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

	Fair Value Measurements at March 31, 2018, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real Estate:				
1-4 family residential construction	$—	$ —	$ —	$—
Other construction/land	—	—	—	—
1-4 family - closed-end	—	5	—	5
Equity lines	—	111	—	111
Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Commercial real estate - non-owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate	—	116	—	116
Agriculture	—	—	—	—
Commercial and industrial	—	112	—	112
Consumer loans	—	70	—	70
Total impaired loans	$—	$ 298	$ —	$298
Foreclosed assets	$—	$ 5,371	$ —	$5,371
Total assets measured on a nonrecurring basis	$—	$ 5,669	$ —	$5,669

	Fair Value Measurements at December 31, 2017, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real Estate:				
1-4 family residential construction	$—	$ —	$ —	$—
Other construction/land	—	—	—	—
1-4 family - closed-end	—	252	—	252
Equity lines	—	70	—	70

Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Commercial real estate - non-owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate	—	322	—	322
Agriculture	—	—	—	—
Commercial and industrial	—	—	—	—
Consumer loans	—	55	—	55
Total impaired loans	$—	$ 377	$ —	$377
Foreclosed assets	$—	$ 5,481	$ —	$5,481
Total assets measured on a nonrecurring basis	$—	$ 5,858	$ —	$5,858

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

13

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

Note 10 – Investments

Investment Securities

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

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

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

	March 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
US Government agencies	$20,173	$ 15	$ (463)	$ 19,725
Mortgage-backed securities	412,457	536	(11,009)	401,984
State and political subdivisions	141,851	1,287	(1,265)	141,873
Total securities	$574,481	$ 1,838	$ (12,737)	$ 563,582

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

At March 31, 2018 and December 31, 2017, the Company had 543 securities and 396 securities, respectively, with gross unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the unrealized losses are other than temporary. Gross unrealized losses on our investment securities as of the indicated dates are disclosed in the table below, categorized by investment type and by the duration of time that loss positions on individual securities have continuously existed (over or under twelve months).

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

	March 31, 2018			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$(120)	$8,653	$(343)	$8,935
Mortgage-backed securities	(4,854)	210,808	(6,155)	163,928
State and political subdivisions	(734)	53,770	(531)	11,536
Total	$(5,708)	$273,231	$(7,029)	$184,399

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

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

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

	Three months ended March 31,	
	2018	2017
Proceeds from sales, calls and maturities of securities available for sale	$200	$12,905
Gross gains on sales, calls and maturities of securities available for sale	$—	$43
Gross losses on sales, calls and maturities of securities	—	(35)

available for sale		
Net gains on sale of securities available for sale	$—	$8

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

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

	March 31, 2018	
	Amortized Cost	Fair Value
Maturing within one year	$9,906	$9,978
Maturing after one year through five years	223,672	219,895
Maturing after five years through ten years	50,882	50,715
Maturing after ten years	76,382	75,645
Securities not due at a single maturity date:		
US Government agencies collateralized by mortgage obligations	213,639	207,349
	$574,481	$563,582

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

At March 31, 2018, the Company’s investment portfolio included 338 “muni” bonds issued by government municipalities and agencies located within 31 different states, with an aggregate fair value of $142 million. The largest exposure to any single municipality or agency was a combined $2.540 million (fair value) in general obligation bonds issued by the Lindsay (CA) Unified School District.

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

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

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

	March 31, 2018		December 31, 2017	
General obligation bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
State of issuance				
Texas	$33,950	$33,645	$32,824	$33,184
California	27,220	27,618	27,205	28,027
Washington	13,250	13,212	13,282	13,524
Ohio	9,890	9,834	9,917	9,978
Illinois	9,216	9,205	8,822	8,925
Other (22 states)	25,576	25,618	24,591	24,971
Total General Obligation Bonds	119,102	119,132	116,641	118,609
Revenue bonds				
State of issuance				
Texas	6,614	6,622	7,088	7,172
Utah	5,389	5,366	5,397	5,454
Indiana	2,051	2,046	2,664	2,721
Washington	1,761	1,774	1,764	1,811
Virginia	1,608	1,576	1,613	1,626
Other (11 states)	5,326	5,357	5,742	5,808
Total Revenue Bonds	22,749	22,741	24,268	24,592
Total Obligations of States and Political Subdivisions	$141,851	$141,873	$140,909	$143,201

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

Revenue Bonds by Type
(dollars in thousands, unaudited)

	March 31, 2018		December 31, 2017	
Revenue bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Revenue source:				
Water	$6,412	$6,397	$5,160	$5,230
Sales Tax	2,950	2,917	4,375	4,417
College & University	2,351	2,382	3,649	3,715

Lease	2,313	2,326	3,657	3,706
Local or GTD Housing	1,523	1,492	2,076	2,116
Other (13 sources)	7,200	7,227	5,351	5,408
Total Revenue Bonds	$22,749	$22,741	$24,268	$24,592

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

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

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

As of March 31, 2018 our total LIHTC investment book balance was $8.0 million, which includes $3.2 million in remaining commitments for additional capital contributions. There were $160,000 in tax credits derived from our LIHTC investments that were recognized during the three months ended March 31, 2018, and amortization expense of $405,000 associated with those investments was netted against pre-tax non-interest income for the same time period. Our LIHTC investments are evaluated annually for potential impairment, and we have concluded that the carrying value of the investments is stated fairly and is not impaired.

Note 11 – Credit Quality and Nonperforming Assets

Credit Quality Classifications

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

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

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

Credit Quality Classifications

(dollars in thousands, unaudited)

	March 31, 2018				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$81,580	$—	$ —	$—	$81,580
Other construction/land	76,533	253	—	507	77,293
1-4 family - closed end	220,192	1,531	1,220	3,982	226,925
Equity lines	53,292	2,468	351	4,538	60,649
Multi-family residential	42,184	—	—	385	42,569
Commercial real estate - owner occupied	252,844	4,909	2,605	903	261,261
Commercial real estate - non-owner occupied	388,716	2,823	3,879	1,539	396,957
Farmland	141,927	464	505	33	142,929
Total real estate	1,257,268	12,448	8,560	11,887	1,290,163
Agricultural	53,644	626	—	—	54,270
Commercial and industrial	117,026	10,274	967	1,504	129,771
Mortgage warehouse	108,573	—	—	—	108,573
Consumer loans	8,192	292	36	919	9,439
Total gross loans and leases	$1,544,703	$23,640	$ 9,563	$14,310	$1,592,216

	December 31, 2017				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$74,256	$—	$ —	$—	$74,256
Other construction/land	57,421	807	—	551	58,779
1-4 family - closed end	197,309	1,534	1,204	4,719	204,766
Equity lines	53,825	3,620	521	4,624	62,590
Multi-family residential	42,539	—	—	391	42,930
Commercial real estate - owner occupied	255,228	4,586	2,715	918	263,447
Commercial real estate - non-owner occupied	369,801	4,923	3,132	1,576	379,432
Farmland	138,732	984	507	293	140,516
Total real estate	1,189,111	16,454	8,079	13,072	1,226,716
Agricultural	46,182	614	—	—	46,796
Commercial and industrial	108,609	24,008	981	2,064	135,662
Mortgage warehouse	138,020	—	—	—	138,020
Consumer loans	9,067	210	72	1,277	10,626
Total gross loans and leases	$1,490,989	$41,286	$ 9,132	$16,413	$1,557,820

Past Due and Nonperforming Assets

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets. The Company's foreclosed assets can include mobile homes and/or OREO, which consists of commercial and/or residential real estate properties acquired by foreclosure or similar means that the Company is offering or will offer for sale. Foreclosed assets totaled $5.371 million at March 31, 2018, and $5.481 million at December 31, 2017. Nonperforming loans and leases result when reasonable doubt surfaces with regard to the ability of the Company to collect all principal and interest. At that point, we stop accruing interest on the loan or lease in question and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for 90 days or more is also placed on non-accrual status even if interest is still being received, unless the asset is both well secured and in the process of collection. An aging of the Company's loan balances is presented in the following tables, by number of days past due as of the indicated dates:

Loan Portfolio Aging

(dollars in thousands, unaudited)

	March 31, 2018						
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[1]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[2]
Real Estate:							
1-4 family residential construction	$—	$ —	$ —	$—	$81,580	$ 81,580	$ —
Other construction/land	317	—	—	317	76,976	77,293	71
1-4 family - closed end	39	319	601	959	225,966	226,925	910
Equity lines	831	55	208	1,094	59,555	60,649	646
Multi-family residential	—	—	—	—	42,569	42,569	—
Commercial real estate - owner occupied	188	110	—	298	260,963	261,261	227
Commercial real estate - non-owner occupied	—	—	—	—	396,957	396,957	105
Farmland	18	—	—	18	142,911	142,929	33
Total real estate	1,393	484	809	2,686	1,287,477	1,290,163	1,992
Agricultural	—	—	—	—	54,270	54,270	—
Commercial and industrial	2,240	92	859	3,191	126,580	129,771	963
Mortgage warehouse lines	—	—	—	—	108,573	108,573	—
Consumer	151	56	37	244	9,195	9,439	134
Total gross loans and leases	$3,784	$ 632	$ 1,705	$ 6,121	$1,586,095	$ 1,592,216	$ 3,089

[1] As of March 31, 2018 there were no loans over 90 days past due and still accruing.
[2] Included in total financing receivables

	December 31, 2017						
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[1]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[2]
Real Estate:							
1-4 family residential construction	$—	$ —	$ —	$—	$74,256	$ 74,256	$ —
Other construction/land	20	—	—	20	58,759	58,779	77
1-4 family - closed end	125	—	895	1,020	203,746	204,766	871
Equity lines	466	—	203	669	61,921	62,590	922
Multi-family residential	—	—	—	—	42,930	42,930	—
Commercial real estate -	1,270	—	—	1,270	262,177	263,447	236

owner occupied							
Commercial real estate - non-owner occupied	—	—	—	—	379,432	379,432	123
Farmland	—	—	—	—	140,516	140,516	293
Total real estate	1,881	—	1,098	2,979	1,223,737	1,226,716	2,522
Agricultural	—	—	—	—	46,796	46,796	—
Commercial and industrial	730	496	1,172	2,398	133,264	135,662	1,301
Mortgage warehouse lines	—	—	—	—	138,020	138,020	—
Consumer	157	64	46	267	10,359	10,626	140
Total gross loans and leases	$2,768	$ 560	$ 2,316	$ 5,644	$1,552,176	$ 1,557,820	$ 3,963

(1) As of December 31, 2017 there were no loans over 90 days past due and still accruing.
(2) Included in total financing receivables

Troubled Debt Restructurings

A loan that is modified for a borrower who is experiencing financial difficulty is classified as a troubled debt restructuring if the modification constitutes a concession. At March 31, 2018, the Company had a total of $12.1 million in TDRs, including $895,000 in TDRs that were on non-accrual status. Generally, a non-accrual loan that has been modified as a TDR remains on non-accrual status for a period of at least six months to demonstrate the borrower's ability to comply with the modified terms. However, performance prior to the modification, or significant events that coincide with the modification, could result in a loan's return to accrual status after a shorter performance period or even at the time of loan modification. Regardless of the period of time that has elapsed, if the borrower's ability to meet the revised payment schedule is uncertain then the loan will be kept on non-accrual status. Moreover, a TDR is generally considered to be in default when it appears that the customer will not likely be able to repay all principal and interest pursuant to restructured terms.

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

Troubled Debt Restructurings, by Type of Loan Modification

(dollars in thousands, unaudited)

	Three months ended March 31, 2018			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real Estate:				
Other construction/land	$—	$ —	$ —	$ —
1-4 family - closed-end	—	—	—	—
Equity lines	68	—	—	68
Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate loans	68	—	—	68
Commercial and industrial	—	—	—	—
Consumer loans	—	—	—	—
Total	$68	$ —	$ —	$ 68

	Three months ended March 31, 2017			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real Estate:				
Other construction/land	$—	$ —	$ —	$—
1-4 family - closed-end	—	—	47	47
Equity lines	281	—	—	281
Multi-family residential	—	—	—	—
Commercial real estate - owner occupied	—	—	—	—
Farmland	—	—	—	—
Total real estate loans	281	—	47	328

Commercial and industrial	—	—	—	—
Consumer loans	—	—	—	—
Total	$281	$ —	$ 47	$328

The following tables present, by class, additional details related to loans classified as TDRs during the referenced periods, including the recorded investment in the loan both before and after modification and balances that were modified during the period:

Troubled Debt Restructurings

(dollars in thousands, unaudited)

	Three months ended March 31, 2018				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference [1]	Reserve
Real Estate:					
Other construction/land	0	$ —	$ —	$ —	$ —
1-4 family - closed-end	0	—	—	—	—
Equity lines	1	68	68	—	2
Multi-family residential	0	—	—	—	—
Commercial real estate - owner occupied	0	—	—	—	—
Farmland	0	—	—	—	—
Total real estate loans		68	68	—	2
Commercial and industrial	0	—	—	—	—
Consumer loans	0	—	—	—	—
Total		$ 68	$ 68	$ —	$ 2

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

	Three months ended March 31, 2017				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference [1]	Reserve

Real Estate:					
Other construction/land	0	$ —	$ —	$ —	$ —
1-4 family - closed-end	1	47	47	2	2
Equity lines	2	281	281	4	14
Multi-family residential	0	—	—	—	—
Commercial real estate - owner occupied	0	—	—	—	—
Farmland	0	—	—	—	—
Total real estate loans		328	328	6	16
Commercial and industrial	0	—	—	—	—
Consumer loans	0	—	—	—	—
Total		$ 328	$ 328	$ 6	$ 16

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

The company had no finance receivables modified as TDRs within the previous twelve months that defaulted or were charged off during the three-month periods ended March 31, 2018 and 2017.

Purchased Credit Impaired Loans

The Company may acquire loans which show evidence of credit deterioration since origination. These purchased credit impaired ("PCI") loans are recorded at the amount paid, since there is no carryover of the seller's allowance for loan losses. Potential losses on PCI loans subsequent to acquisition are recognized by an increase in the allowance for loan losses. PCI loans are accounted for individually or are aggregated into pools of loans based on common risk characteristics. The Company projects the amount and timing of expected cash flows, and expected cash receipts in excess of the amount paid for the loan(s) are recorded as interest income over the remaining life of the loan or pool of loans (accretable yield). The excess of contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Expected cash flows are periodically re-evaluated throughout the life of the loan or pool of loans. If the present value of the expected cash flows is determined at any time to be less than the carrying amount, a reserve is recorded. If the present value of the expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Our acquisitions of Santa Clara Valley Bank in 2014, Coast Bancorp in 2016, and OCB Bancorp in 2017 included certain loans which have shown evidence of credit deterioration since origination, and for which it was probable at acquisition that all contractually required payments would not be collected. The carrying amount and unpaid principal balance of those PCI loans was as follows, as of the dates indicated:

Purchased Credit Impaired Loans:

(dollars in thousands, unaudited)

	March 31, 2018	
	Unpaid Principal Balance	Carrying Value
Real estate secured	$147	$ 12
Commercial and industrial	—	—
Total purchased credit impaired loans	$147	$ 12

	December 31, 2017	
	Unpaid Principal Balance	Carrying Value
Real estate secured	$148	$ 17
Commercial and industrial	—	—
Total purchased credit impaired loans	$148	$ 17

An allowance for loan losses totaling $135,000 was allocated for PCI loans as of March 31, 2018, as compared to $131,000 at December 31, 2017. There was no discount accretion recorded on PCI loans during the three months ended March 31, 2018.

Note 12 – Allowance for Loan and Lease Losses

The Company's allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. The allowance is maintained at a level that is considered adequate to absorb probable losses on certain specifically identified impaired loans, as well as probable incurred losses inherent in the remaining loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it to that level at least quarterly. Pursuant to our methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary.

The following tables disclose the unpaid principal balance, recorded investment, average recorded investment, and interest income recognized for impaired loans on our books as of the dates indicated. Balances are shown by loan type, and are further broken out by those that required an allowance and those that did not, with the associated allowance disclosed for those that required such. Included in the valuation allowance for impaired loans shown in the tables below are specific reserves allocated to TDRs, totaling $911,000 at March 31, 2018 and $957,000 at December 31, 2017.

Impaired Loans
(dollars in thousands, unaudited)

	March 31, 2018				
				Average	
	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Recorded Investment	Interest Income Recognized[3]
With an allowance recorded					
Real Estate:					
Other construction/land	$636	$ 480	$ 27	$ 725	$ 9
1-4 family - closed-end	3,056	3,056	68	3,148	43
Equity lines	4,325	4,240	483	4,457	47
Multi-family residential	385	385	28	399	5
Commercial real estate- owner occupied	911	791	169	885	13
Commercial real estate- non-owner occupied	1,686	1,539	3	1,839	27
Total real estate	10,999	10,491	778	11,453	144
Agriculture	—	—	—	—	—
Commercial and industrial	1,677	1,482	958	1,971	11
Consumer loans	941	894	158	1,089	17
Subtotal	13,617	12,867	1,894	14,513	172
With no related allowance recorded					
Real Estate:					
Other construction/land	27	27	—	32	—
1-4 family - closed-end	984	926	—	1,025	1
Equity lines	397	298	—	408	—
Commercial real estate- owner occupied	112	112	—	150	—
Commercial real estate- non-owner occupied	9	—	—	17	—
Farmland	33	33	—	48	—
Total real estate	1,562	1,396	—	1,680	1
Agriculture	—	—	—	—	—
Commercial and industrial	22	22	—	34	—
Consumer loans	130	25	—	196	—
Subtotal	1,714	1,443	—	1,910	1
Total	$15,331	$ 14,310	$ 1,894	$ 16,423	$ 173

(1) Contractual principal balance due from customer.
(2) Principal balance on Company's books, less any direct charge offs.
(3) Interest income is recognized on performing balances on a regular accrual basis.

Impaired Loans
(dollars in thousands, unaudited)

	December 31, 2017				
	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Average Recorded Investment	Interest Income Recognized[3]
With an allowance recorded					
Real Estate:					
Other construction/land	$678	$ 523	$ 30	$ 768	$ 44
1-4 family - closed-end	4,061	4,054	109	4,042	226
Equity lines	4,546	4,446	405	4,711	154
Multi-family residential	390	391	29	410	24
Commercial real estate- owner occupied	926	801	151	948	44
Commercial real estate- non-owner occupied	1,724	1,576	4	1,914	111
Total real estate	12,325	11,791	728	12,793	603
Agriculture	—	—	—	—	—
Commercial and industrial	917	917	188	1,576	83
Consumer loans	1,210	1,201	237	1,433	96
Subtotal	14,452	13,909	1,153	15,802	782
With no related allowance recorded					
Real Estate:					
Other construction/land	28	28	—	34	—
1-4 family - closed-end	885	665	—	746	2
Equity lines	206	178	—	208	—
Commercial real estate- owner occupied	117	117	—	157	—
Commercial real estate- non-owner occupied	10	—	—	25	—
Farmland	293	293	—	327	—
Total real estate	1,539	1,281	—	1,497	2
Agriculture	—	—	—	—	—
Commercial and industrial	1,158	1,147	—	1,433	—
Consumer loans	230	76	—	317	—
Subtotal	2,927	2,504	—	3,247	2
Total	$17,379	$ 16,413	$ 1,153	$ 19,049	$ 784

(1) Contractual principal balance due from customer.
(2) Principal balance on Company's books, less any direct charge offs.
(3) Interest income is recognized on performing balances on a regular accrual basis.

The specific loss allowance for an impaired loan generally represents the difference between the book value of the loan and either the fair value of underlying collateral less estimated disposition costs, or the loan's net present value as determined by a discounted cash flow analysis. The discounted cash flow approach is typically used to measure impairment on loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition or operation of underlying collateral. However, historical loss rates may be used to determine a specific loss allowance if they indicate a higher potential reserve need than the discounted cash flow analysis. Any change in impairment attributable to the passage of time is accommodated by adjusting the loss allowance accordingly.

For loans where repayment is expected to be provided by the disposition or operation of the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition where applicable, is less than the loan balance, then a specific loss reserve is established for the shortfall in collateral coverage. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is required. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal is 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. The specific loss allowance is adjusted, 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 or in process for 94% of the Company's impaired real estate loan balances at March 31, 2018. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if applicable. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Our methodology also provides for the establishment of a "general" allowance for probable incurred losses inherent in loans and leases that are not impaired. Unimpaired loan balances are segregated by credit quality, and are then evaluated in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical loss data and other measurable information, the credit classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on Management's judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that Management believes is appropriate at each reporting date. Quantitative information includes our historical loss experience, delinquency and charge-off trends, and current collateral values. Qualitative factors include the general economic environment in our markets and, in particular, the condition of the agricultural industry and other key industries. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The total general reserve established for probable incurred losses on unimpaired loans was $7.097 million at March 31, 2018.

There were no material changes to the methodology used to determine our allowance for loan and lease losses during the three months ended March 31, 2018, although minor adjustments were made to certain qualitative factor multipliers. As we add new products and expand our geographic coverage, and as the regulatory and economic environments change, we expect 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 DBO review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity.

The tables that follow detail the activity in the allowance for loan and lease losses for the periods noted:

Allowance for Credit Losses and Recorded Investment in Financing Receivables
(dollars in thousands, unaudited)

Three months ended March 31, 2018	Real Estate	Agricultural Products	Commercial and Industrial	Consumer	Unallocated	Total
Allowance for credit losses:						
Beginning Balance	$4,786	$ 208	$ 2,772	$ 1,231	$ 46	$9,043
Charge-offs	(26)	—	(33)	(565)	—	(624)
Recoveries	64	—	29	279	—	372
Provision	12	18	137	57	(24)	200
Ending Balance	$4,836	$ 226	$ 2,905	$ 1,002	$ 22	$8,991
Reserves:						
Specific	$778	$ —	$ 958	$ 158	$ —	$1,894
General	4,058	226	1,947	844	22	7,097
Ending Balance	$4,836	$ 226	$ 2,905	$ 1,002	$ 22	$8,991
Loans evaluated for impairment:						
Individually	$11,887	$ —	$ 1,504	$ 919	$ —	$14,310
Collectively	1,278,276	54,270	236,840	8,520		1,577,906
Ending Balance	$1,290,163	$ 54,270	$ 238,344	$ 9,439	$ —	$1,592,216

Year ended December 31, 2017	Real Estate	Agricultural Products	Commercial and Industrial	Consumer	Unallocated	Total
Allowance for credit losses:						
Beginning Balance	$3,548	$ 209	$ 4,279	$ 1,208	$ 457	$9,701
Charge-offs	(101)	(154)	(669)	(2,161)	—	(3,085)
Recoveries	2,235	5	310	1,017	—	3,567
Provision	(896)	148	(1,148)	1,167	(411)	(1,140)
Ending Balance	$4,786	$ 208	$ 2,772	$ 1,231	$ 46	$9,043
Reserves:						
Specific	$728	$ -	$ 188	$ 237	$ —	$1,153
General	4,058	208	2,584	994	46	7,890
Ending Balance	$4,786	$ 208	$ 2,772	$ 1,231	$ 46	$9,043
Loans evaluated for impairment:						
Individually	$13,072	$ —	$ 2,064	$ 1,277	$ —	$16,413
Collectively	1,213,644	46,796	271,618	9,349	—	1,541,407
Ending Balance	$1,226,716	$ 46,796	$ 273,682	$ 10,626	$ —	$1,557,820

Note 13 – Recent Developments

On October 1, 2017, the Company acquired 100% of the outstanding common shares of Ojai Community Bancorp, parent company to Ojai Community Bank (collectively referred to herein as "Ojai"), in exchange for $809,000 in cash and 1,376,431 shares of Sierra Bancorp stock. Immediately thereafter, Ojai Community Bank was merged into Bank of the Sierra. At the time of the acquisition, the fair value of Ojai’s loans and deposits totaled $218 million and $231 million, respectively. In accordance with GAAP, the Company also recorded $18.5 million of goodwill and $3.5 million of core deposit intangibles in connection with the transaction. The core deposit intangible is being amortized on a straight line basis over eight years. The conversion of Ojai’s core banking system to Bank of the Sierra’s core system took place on November 3, 2017.

Furthermore, on November 3, 2017 the Company acquired the Woodlake branch of Citizen’s Business Bank. Woodlake branch deposits totaled approximately $27 million at the acquisition date, consisting largely of non-maturity deposits. The acquisition also included the purchase of the Woodlake branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $500,000. In accordance with GAAP, the Company recorded $625,000 of goodwill and $486,000 of core deposit intangibles in conjunction with the transaction. The core deposit intangible is being amortized on a straight line basis over eight years.

On January 23, 2018, the Bank announced that it has entered into an agreement with Community Bank of Santa Maria to acquire its branch located in Lompoc, California (Santa Barbara County). The transaction is expected to close in May of 2018, subject to customary closing conditions. Subsequent to the acquisition, the Lompoc branch will operate as a full-service branch of Bank of the Sierra. Lompoc branch deposits totaled $40 million at March 31 2018, consisting largely of non-maturity deposits. The acquisition agreement also contemplates that Bank of the Sierra will purchase the Lompoc branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $1.7 million.

PART I - FINANCIAL INFORMATION

ITEM 2

MANAGEMENT’S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as “expects”, “anticipates”, “believes”, “projects”, and “estimates” or variations of such words and similar expressions are intende to identify forward-looking statements. These statements are based on certain underlying assumptions and are not guarantees of future performance, as they could be impacted by a number of potential risks and developments that cannot be predicted with any degree of certainty. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company’s financial condition or results of operations, and should be considered when evaluating the Company’s potential future financial performance. They include, but are not limited to, the risk of unfavorable economic conditions in the Company’s market areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; reductions in the market value of available-for-sale securities that could result if interest rates increase substantially or an issuer has real or perceived financial difficulties; the Company’s ability to attract and retain skilled employees; the Company’s ability to successfully deploy new technology; the success of acquisitions or branch expansion; and risks associated with the multitude of current and prospective laws and regulations to which the Company is and will be subject. Risk factors that could cause actual results to differ materially from results that might be implied by forward-looking statements include the risk factors disclosed in the Company’s Form 10-K for the fiscal year ended December 31, 2017.

CRITICAL ACCOUNTING POLICIES

The Company’s financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management’s estimates and judgments, which are based on historical experience and incorporate various assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company’s stated results of operations. In Management’s opinion, the Company’s critical accounting policies deal with the following areas: the establishment of the allowance for loan and lease losses, as explained in detail in Note 12 to the consolidated financial statements and in the “Provision for Loan and Lease Losses” and “Allowance for Loan and Lease Losses” sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 11 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the “Provision for Income Taxes” and “Other Assets” sections of this discussion and analysis; and goodwill and other intangible assets, which are evaluated annually for impairment and for which we have determined that no impairment exists, as discussed in the “Other Assets” section of this discussion and analysis. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate our most recent expectations with regard to those areas.

OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

results of operations Summary

First Quarter 2018 compared to First Quarter 2017

Net income for the quarter ended March 31, 2018 was $6.710 million, representing an increase of $2.159 million, or 47%, relative to net income of $4.551 million for the quarter ended March 31, 2017. Basic and diluted earnings per share for the first quarter of 2018

29

were both $0.44, compared to $0.33 basic earnings per share and $0.32 diluted earnings per share for the first quarter of 2017. The Company's annualized return on average equity was 10.61% and annualized return on average assets was 1.16% for the quarter ended March 31, 2018, compared to 8.85% and 0.94%, respectively, for the quarter ended March 31, 2017. The primary drivers behind the variance in first quarter net income are as follows:

- Net interest income increased by $4.877 million, or 29%, due to growth in average interest-earning assets totaling $327 million, or 18%, and an increase of 30 basis points in our net interest margin for the comparative quarters. Organic growth was a factor in the increase in average earning assets, but the comparative results were also materially affected by our acquisition of Ojai Community Bank in the fourth quarter of 2017. Our net interest margin improvement resulted in part from strong growth in loans relative to lower-yielding investment balances, as well as the benefit provided by our asset-sensitive interest rate risk position in a rising interest rate environment.
- We recorded a $200,000 loan loss provision in the first quarter of 2018 relative to no provision in the first quarter of 2017.
- Total non-interest income was the same in the first quarter of 2018 as in the first quarter of 2017, since an increase in core service charges on deposits was offset by lower income on bank-owned life insurance and a drop in other non-interest income.
- Total non-interest expense increased by $2.186 million, or 14%, due primarily to ongoing operating costs associated with our recent acquisitions, as well as costs for de novo branch offices that commenced operations in 2017. We also recorded $286,000 in nonrecurring acquisition costs in the first quarter of 2018.
- While pre-tax income increased by 39%, net income reflects a higher percentage increase due to a lower corporate income tax rate in 2018. The Company's provision for income taxes declined to 24% of pre-tax income in the first quarter of 2018 from 28% in the first quarter of 2017.

Financial Condition Summary

March 31, 2018 relative to December 31, 2017

The Company's assets totaled $2.374 billion at March 31, 2018, relative to $2.340 billion at December 31, 2017. Total liabilities were $2.118 billion at March 31, 2018 compared to $2.084 billion at the end of 2017, and shareholders' equity totaled $255 million at March 31, 2018 compared to $256 million at December 31, 2017. The following provides a summary of key balance sheet changes during the first three months of 2018:

- Gross loans increased by $34 million, or 2%, due to strong growth in real estate loans and agricultural loans that was partially offset by a drop of $29 million, or 21%, in mortgage warehouse loans.
- Total nonperforming assets, namely non-accrual loans and foreclosed assets, were reduced by 984,000, or 10%. The Company's ratio of nonperforming assets to total loans plus foreclosed assets was 0.53% at March 31, 2018, compared to 0.60% at December 31, 2017.
- Deposits were up $48 million, or 2%, for the first three months of 2018, ending the period at $2.037 billion due in part to seasonal growth in balances.
- Junior subordinated debentures increased slightly from accretion of the discount on trust-preferred securities gained in the Coast acquisition, but other borrowings were reduced by $11 million, or 38%, as facilitated by deposit growth.
- Total capital of $255 million at March 31, 2018 reflects a slight decline relative to year-end 2017, due to an increase in our accumulated other comprehensive loss which was partially offset by capital from stock options exercised and the addition of income, net of dividends paid. Our consolidated total risk-based capital ratio was 15.32% at both March 31, 2018 and December 31, 2017, and our regulatory capital ratios remain strong relative to peer banks.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expense is comprised of operating costs that facilitate offering a full range of banking services to our customers.

30

Net interest income AND NET INTEREST MARGIN

Net interest income increased by $4.877 million, or 29%, for the first quarter of 2018 relative to the first quarter of 2017. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

The following table shows average balances for significant balance sheet categories and the amount of interest income or interest expense associated with each category for the noted periods. The table also displays calculated yields on each major component of the Company's investment and loan portfolios, average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin for the noted periods.

Average Balances and Rates
(dollars in thousands, unaudited)

	For the three months ended Ended March 31, 2018				For the three months ended Ended March 31, 2017			
Assets	Average Balance [1]	Income/ Expense	Average Rate/Yield [2]		Average Balance [1]	Income/ Expense	Average Rate/Yield [2]	
Investments:								
Federal funds sold/due from time	$30,476	$118	1.55	%	$56,658	$114	0.80	%
Taxable	425,075	2,338	2.20	%	424,763	2,008	1.89	%
Non-taxable	141,579	1,016	3.63	%	116,049	805	4.27	%
Equity	—	—	—		1,605	5	1.25	%
Total investments	597,130	3,472	2.51	%	599,075	2,932	2.25	%
Loans and Leases:[3]								
Real estate	1,254,596	16,644	5.38	%	927,531	11,608	5.08	%
Agricultural	50,131	658	5.32	%	47,508	556	4.75	%
Commercial	127,316	1,379	4.39	%	120,075	1,499	5.06	%
Consumer	10,493	293	11.32	%	12,095	347	11.64	%
Mortgage warehouse lines	83,348	978	4.76	%	90,030	917	4.13	%
Other	3,013	52	7.00	%	2,979	43	5.85	%
Total loans and leases	1,528,897	20,004	5.31	%	1,200,218	14,970	5.06	%
Total interest earning assets [4]	2,126,027	23,476	4.53	%	1,799,293	17,902	4.13	%
Other earning assets	10,195				8,506			
Non-earning assets	201,397				155,246			
Total assets	$2,337,619				$1,963,045			
Liabilities and shareholders' equity								
Interest bearing deposits:								
Demand deposits	$116,829	$88	0.31	%	$134,717	$101	0.30	%
NOW	409,198	117	0.12	%	368,612	102	0.11	%
Savings accounts	293,716	76	0.10	%	221,449	63	0.12	%
Money market	164,824	42	0.10	%	120,367	23	0.08	%
CDAR's	—	—	—		128	—	—	
Certificates of deposit, under $100,000	81,699	108	0.54	%	74,704	58	0.31	%
Certificates of deposit, $100,000 or more	294,019	887	1.22	%	267,885	342	0.52	%
Total interest bearing deposits	1,360,285	1,318	0.39	%	1,187,862	689	0.24	%
Borrowed Funds:								
Federal funds purchased	10	—	—		3	—	—	
Repurchase agreements	9,805	10	0.41	%	8,157	8	0.40	%
Short term borrowings	944	3	1.29	%	1,648	2	0.49	%
TRUPS	34,606	385	4.51	%	34,428	320	3.77	%
Total borrowed funds	45,365	398	3.56	%	44,236	330	3.03	%
Total interest bearing liabilities	1,405,650	1,716	0.50	%	1,232,098	1,019	0.34	%
Demand deposits - non-interest bearing	643,524				495,656			
Other liabilities	31,936				26,817			
Shareholders' equity	256,509				208,474			
	$2,337,619				$1,963,045			

Total liabilities and shareholders' equity	
Interest income/interest earning assets	