TRICO BANCSHARES /
Form 10-K
March 14, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2011

Commission File Number 0-10661

TriCo Bancshares

(Exact name of Registrant as specified in its charter)

California	**94-2792841**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
63 Constitution Drive, Chico, California	**95973**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code:(530) 898-0300

Securities registered pursuant to Section 12(b) of the Act:

(Title of Class)	(Name of each exchange on which registered)
Common Stock, without par value	Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None.

Indicate by check mark whether the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ¨ NO x

Indicate by check mark whether the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ¨ NO x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The aggregate market value of the voting common stock held by non-affiliates of the Registrant, as of June 30, 2011, was approximately $173,871,000 (based on the closing sales price of the Registrant s common stock on the date). This computation excludes a total of 3,612,536 shares that are beneficially owned by the officers and directors of Registrant who may be deemed to be the affiliates of Registrant under applicable rules of the Securities and Exchange Commission.

The number of shares outstanding of Registrant s common stock, as of March 2, 2012, was 15,978,958 shares of common stock, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

The information required to be disclosed pursuant to Part III of this report either shall be (i) deemed to be incorporated by reference from selected portions of TriCo Bancshares definitive proxy statement for the 2012 annual meeting of stockholders, if such proxy statement is filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the Company s most recently completed fiscal year, or (ii) included in an amendment to this report filed with the Commission on Form 10-K/A not later than the end of such 120 day period.

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FORWARD-LOOKING STATEMENTS

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements about TriCo Bancshares (the Company) for which it claims the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on Management s current knowledge and belief and include information concerning the Company s possible or assumed future financial condition and results of operations. When you see any of the words believes , expects , anticipates , estimates or similar expressions, these generally indicate that we are making forward-looking statements. A number of factors, some of which are beyond the Company s ability to predict or control, could cause future results to differ materially from those contemplated. These factors include those listed at Item 1A Risk Factors, in this report.

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PART I

ITEM 1. BUSINESS

Information About TriCo Bancshares Business

TriCo Bancshares (the Company , TriCo , we or our) was incorporated in California on October 13, 1981. It was organized at the direction of the board of directors of Tri Counties Bank (the Bank) for the purpose of serving as a bank holding company for the Bank. On September 7, 1982, the shareholders of Tri Counties Bank became the shareholders of TriCo and Tri Counties Bank became a wholly owned subsidiary of TriCo. At that time, TriCo became a bank holding company subject to the supervision of the Board of Governors of the Federal Reserve System (FRB) under the Bank Holding Company Act of 1956, as amended. Tri Counties Bank remains subject to the supervision of the California Department of Financial Institutions (DFI) and the Federal Deposit Insurance Corporation (FDIC). On July 31, 2003, the Company formed a subsidiary business trust, TriCo Capital Trust I, to issue trust preferred securities. On June 22, 2004, the Company formed a subsidiary business trust, TriCo Capital Trust II, to issue additional trust preferred securities. See Note 17 in the financial statements at Item 8 of this report for a discussion about the Company s issuance of trust preferred securities. Tri Counties Bank, TriCo Capital Trust I and TriCo Capital Trust II currently are the only subsidiaries of TriCo and TriCo is not conducting any business operations independent of Tri Counties Bank, TriCo Capital Trust I and TriCo Capital Trust II.

For financial reporting purposes, the financial statements of the Bank are consolidated into the financial statements of the Company. Historically, issuer trusts, such as TriCo Capital Trust I and TriCo Capital Trust II, that issued trust preferred securities have been consolidated by their parent companies and trust preferred securities have been treated as eligible for Tier 1 capital treatment by bank holding companies under FRB rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. Applying the provisions of the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) 810 Consolidation , the Company is no longer permitted to consolidate such issuer trusts beginning on December 31, 2003. The FRB permits trust preferred securities to be treated as Tier 1 up to a limit of 25% of Tier 1 capital.

Additional information concerning the Company can be found on our website at www.tcbk.com. Copies of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports are available free of charge through our website, www.tcbk.com, at Investor Relations SEC Filings and Annual Reports as soon as reasonably practicable after the Company files these reports to the Securities and Exchange Commission. The information on our website is not incorporated into this annual report.

Business of Tri Counties Bank

Tri Counties Bank was incorporated as a California banking corporation on June 26, 1974, and received its certificate of authority to begin banking operations on March 11, 1975. Tri Counties Bank engages in the general commercial banking business in the California counties of Butte, Contra Costa, Del Norte, Fresno, Glenn, Kern, Lake, Lassen, Madera, Mendocino, Merced, Napa, Nevada, Placer, Sacramento, Shasta, Siskiyou, Stanislaus, Sutter, Tehama, Tulare, Yolo and Yuba. Tri Counties Bank currently operates from 41 traditional branches and 27 in-store branches.

General Banking Services

The Bank conducts a commercial banking business including accepting demand, savings and time deposits and making commercial, real estate, and consumer loans. It also offers installment note collection, issues cashier s checks, sells travelers checks and provides safe deposit boxes and other customary banking services. Brokerage services are provided at the Bank s offices by the Bank s association with Raymond James Financial Services, Inc., an independent financial services provider and broker-dealer. The Bank does not offer trust services or international banking services.

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The Bank has emphasized retail banking since it opened. Most of the Bank s customers are retail customers and small to medium-sized businesses. The Bank emphasizes serving the needs of local businesses, farmers and ranchers, retired individuals and wage earners. The majority of the Bank s loans are direct loans made to individuals and businesses in northern and central California where its branches are located. At December 31, 2011, the total of the Bank s consumer loans net of deferred fees outstanding was $406,330,000 (26.2%), the total of commercial loans outstanding was $139,131,000 (9.0%), and the total of real estate loans including construction loans of $39,649,000 was $1,005,571,000 (64.8%). The Bank takes real estate, listed and unlisted securities, savings and time deposits, automobiles, machinery, equipment, inventory, accounts receivable and notes receivable secured by property as collateral for loans.

Most of the Bank s deposits are attracted from individuals and business-related sources. No single person or group of persons provides a material portion of the Bank s deposits, the loss of any one or more of which would have a materially adverse effect on the business of the Bank, nor is a material portion of the Bank s loans concentrated within a single industry or group of related industries.

In order to attract loan and deposit business from individuals and small to medium-sized businesses, branches of the Bank set lobby hours to accommodate local demands. In general, lobby hours are from 9:00 a.m. to 5:00 p.m. Monday through Thursday, and from 9:00 a.m. to 6:00 p.m. on Friday. Some Bank offices also utilize drive-up facilities operating from 9:00 a.m. to 6:00 p.m. The supermarket branches are open from 9:00 a.m. to 7:00 p.m. Monday through Saturday and 11:00 a.m. to 5:00 p.m. on Sunday.

The Bank offers 24-hour ATMs at all branch locations. The Bank s 76 ATMs are linked to several national and regional networks such as CIRRUS and STAR. In addition, banking by telephone on a 24-hour toll-free number is available to all customers. This service allows a customer to obtain account balances and most recent transactions, transfer moneys between accounts, make loan payments, and obtain interest rate information.

In February 1998, the Bank became the first bank in the Northern Sacramento Valley to offer banking services on the Internet. This banking service provides customers one more tool to access their accounts.

Purchase and Assumption of Certain Assets and Liabilities of Citizens Bank of Northern California

On September 23, 2011, the Bank acquired certain of the assets and assumed substantially all of the liabilities of Citizens Bank of Northern California, Nevada City, California (Citizens), including substantially all the deposits from the FDIC, as receiver for Citizens. The acquisition was made pursuant to the terms of a purchase and assumption agreement entered into by the Bank and the FDIC. Based upon a preliminary closing with the FDIC as of September 23, 2011, the Bank acquired $167.5 million in loans, $9.4 million in investment securities, and $93.5 million in cash and other assets, and assumed an estimated $239.9 million in deposits, $22.0 million in borrowings, and $0.1 million in other liabilities. The Bank paid no cash or other consideration to acquire Citizens. See Note 2 in the financial statements at Item 8 of this report for a discussion about this transaction.

Purchase and Assumption of Certain Assets and Liabilities of Granite Community Bank

On May 28, 2010, the Bank acquired certain of the assets and assumed substantially all of the liabilities of Granite Community Bank, N.A., Granite Bay, California (Granite), including substantially all the deposits from the FDIC, as receiver for Granite. The acquisition was made pursuant to the terms of a purchase and assumption agreement entered into by the Bank and the FDIC. The Bank acquired $77.0 million in loans, $3.8 million in investment securities, and $22.2 million in cash and other assets, and assumed an estimated $94.8 million in deposits, $5.0 million in borrowings, and $0.1 million in other liabilities. The Bank paid no cash or other consideration to acquire Granite. In connection with the Acquisition, the Bank entered into a loss-sharing agreement with the FDIC that covered approximately $89.3 million of Granite s assets. The Bank will share in the losses on the asset pools (loans, foreclosed loan collateral, and certain investment securities) covered under the loss-sharing agreement. Pursuant to the terms of the loss sharing agreement, the FDIC is obligated to reimburse the Bank for 80% of losses with respect to covered assets. The Bank will reimburse the FDIC for 80% of recoveries with respect to losses for which the FDIC paid the Bank under the loss sharing agreement. See Note 2 in the financial statements at Item 8 of this report for a discussion about this transaction.

Other Activities

The Bank may in the future engage in other businesses either directly or indirectly through subsidiaries acquired or formed by the Bank subject to regulatory constraints. See Regulation and Supervision.

Employees

At December 31, 2011, the Company and the Bank employed 799 persons, including seven executive officers. Full time equivalent employees were 718. No employees of the Company or the Bank are presently represented by a union or covered under a collective bargaining agreement. Management believes that its employee relations are excellent.

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Competition

The banking business in California generally, and in the Bank s primary service area of Northern and Central California specifically, is highly competitive with respect to both loans and deposits. It is dominated by a relatively small number of national and regional banks with many offices operating over a wide geographic area. Among the advantages such major banks have over the Bank is their ability to finance wide ranging advertising campaigns and to allocate their investment assets to regions of high yield and demand. By virtue of their greater total capitalization such institutions have substantially higher lending limits than does the Bank.

In addition to competing with savings institutions, commercial banks compete with other financial markets for funds as a result of the deregulation of the financial services industry. Yields on corporate and government debt securities and other commercial paper may be higher than on deposits, and therefore affect the ability of commercial banks to attract and hold deposits. Commercial banks also compete for available funds with money market instruments and mutual funds. During past periods of high interest rates, money market funds have provided substantial competition to banks for deposits and they may continue to do so in the future. Mutual funds are also a major source of competition for savings dollars.

The Bank relies substantially on local promotional activity, personal contacts by its officers, directors, employees and shareholders, extended hours, personalized service and its reputation in the communities it services to compete effectively.

Regulation and Supervision

General

The Company and the Bank are subject to extensive regulation under both federal and state law. This regulation is intended primarily for the protection of depositors, the deposit insurance fund, and the banking system as a whole, and not for the protection of shareholders of the Company. Set forth below is a summary description of the significant laws and regulations applicable to the Company and the Bank. The description is qualified in its entirety by reference to the applicable laws and regulations.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law. The Dodd-Frank Act is intended to effect a fundamental restructuring of federal banking regulation. Among other things, the Dodd-Frank Act creates a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. The Dodd-Frank Act also creates a new independent federal regulator to administer federal consumer protection laws. The Dodd-Frank Act is expected to have a significant impact on our business operations as its provisions take effect. Among the provisions that are likely to affect us are the following:

Holding Company Capital Requirements. The Dodd-Frank Act requires the FRB to apply consolidated capital requirements to depository institution holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than $15 billion in assets. The Dodd-Frank Act also requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Deposit Insurance. The Dodd-Frank Act permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, and extends unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, the Dodd-Frank Act eliminates the federal statutory prohibition against the payment of interest on business checking accounts.

Corporate Governance. The Dodd-Frank Act will require publicly traded companies to give shareholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called golden parachute payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The new legislation also authorizes the SEC to promulgate rules that would allow shareholders to nominate their own candidates using a company s proxy materials. The Dodd-Frank Act directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded or not. It also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Prohibition Against Charter Conversions of Troubled Institutions. Effective one year after enactment, the Dodd-Frank Act prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days.

Interstate Branching. The Dodd-Frank Act authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted to branch. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

Limits on Derivatives. Effective 18 months after enactment, the Dodd-Frank Act prohibits state-chartered banks from engaging in derivatives transactions unless the loans to one borrower limits of the state in which the bank is chartered take into consideration credit exposure to derivatives transactions. For this purpose, derivative transaction includes any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities securities, currencies, interest or other rates, indices or other assets.

Transactions with Affiliates and Insiders. Effective one year from the date of enactment, the Dodd-Frank Act expands the definition of affiliate for purposes of quantitative and qualitative limitations of Section 23A of the Federal Reserve Act to include mutual funds advised by a depository institution or its affiliates. The Dodd-Frank Act will apply Section 23A and Section 22(h) of the Federal Reserve Act (governing transactions with insiders) to derivative transactions, repurchase agreements and securities lending and borrowing transactions that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. The current exemption from Section 23A for transactions with financial subsidiaries will be eliminated.

Consumer Financial Protection Bureau. The Dodd-Frank Act creates a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, the Dodd-Frank Act will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Regulatory Agencies

The Company is a legal entity separate and distinct from the Bank and its other subsidiaries. As a bank holding company, the Company is regulated under the Bank Holding Company Act of 1956 (the BHC Act), and is subject to supervision, regulation and inspection by the FRB. The Company is also under the jurisdiction of the Securities and Exchange Commission (SEC) and is subject to the disclosure and regulatory requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, each administered by the SEC. The Company is listed on the Nasdaq Global Select market (Nasdaq) under the trading symbol TCBK and is subject to the rules of Nasdaq for listed companies.

The Bank, as a state chartered bank, is subject to broad federal regulation and oversight extending to all its operations by the FDIC and to state regulation by the DFI.

The Bank Holding Company Act

The Company is a bank holding company. In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve has determined to be so closely related to banking as to be a proper incident thereto. As a result of the Gramm-Bliley Act, which amended the BHC Act, bank holding companies that are financial holding companies may engage in any activity, or acquire and retain the shares of a company engaged in any activity, that is either (i) financial in nature or incidental to such financial activity (as determined by the FRB in consultation with the Office of the Comptroller of the Currency (the OCC)) or (ii) complementary to a financial activity, and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally (as determined solely by the FRB). Activities that are financial in nature include securities underwriting and dealing, insurance underwriting and agency, and making merchant banking investments.

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If a bank holding company seeks to engage in the broader range of activities that are permitted under the BHC Act for financial holding companies, (i) all of its depository institution subsidiaries must be well capitalized and well managed and (ii) it must file a declaration with the FRB that it elects to be a financial holding company. A depository institution subsidiary is considered to be well capitalized if it satisfies the requirements for this status discussed in the section captioned Capital Adequacy and Prompt Corrective Action, included elsewhere in this item. A depository institution subsidiary is considered well managed if it received a composite rating and management rating of at least satisfactory in its most recent examination. In addition, the subsidiary depository institution must have received a rating of at least satisfactory in its most recent examination under the Community Reinvestment Act. (See the section captioned Consumer Protection Laws and Regulations included elsewhere in this item.) The Company has not elected to become a financial holding company.

The BHC Act, the Federal Bank Merger Act, and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the FRB for the direct or indirect acquisition of more than 5 percent of the voting shares of a commercial bank or its parent holding company. Under the Federal Bank Merger Act, the prior approval of an acquiring bank s primary federal regulator is required before it may merge with another bank or purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the applicant s performance record under the Community Reinvestment Act, fair housing laws and the effectiveness of the subject organizations in combating money laundering activities.

Safety and Soundness Standards

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) implemented certain specific restrictions on transactions and required the regulators to adopt overall safety and soundness standards for depository institutions related to internal control, loan underwriting and documentation, and asset growth. Among other things, FDICIA limits the interest rates paid on deposits by undercapitalized institutions, the use of brokered deposits and the aggregate extension of credit by a depository institution to an executive officer, director, principal stockholder or related interest, and reduces deposit insurance coverage for deposits offered by undercapitalized institutions for deposits by certain employee benefits accounts.

Section 39 to the Federal Deposit Insurance Act requires the agencies to establish safety and soundness standards for insured financial institutions covering:

- internal controls, information systems and internal audit systems;
- loan documentation;
- credit underwriting;
- interest rate exposure;
- asset growth;
- compensation, fees and benefits;
- asset quality, earnings and stock valuation; and
- excessive compensation for executive officers, directors or principal shareholders which could lead to material financial loss.

If an agency determines that an institution fails to meet any standard established by the guidelines, the agency may require the financial institution to submit to the agency an acceptable plan to achieve compliance with the standard. If the agency requires submission of a compliance plan and the institution fails to timely submit an acceptable plan or to implement an accepted plan, the agency must require the institution to correct the deficiency. An institution must file a compliance plan within 30 days of a request to do so from the institution s primary federal regulatory agency. The agencies may elect to initiate enforcement action in certain cases rather than rely on an existing plan particularly where failure to meet one or more of the standards could threaten the safe and sound operation of the institution.

Restrictions on Dividends and Distributions

A California corporation such as TriCo may make a distribution to its shareholders if the corporation s retained earnings equal at least the amount of the proposed distribution or if after giving effect to the distribution, the value of the corporation s assets exceed the amount of its liabilities plus the amount of shareholders preferences, if any, and certain other conditions are met.

The primary source of funds for payment of dividends by TriCo to its shareholders will be the receipt of dividends and management fees from the Bank. TriCo s ability to receive dividends from the Bank is limited by applicable state and federal law. Under the California Financial Code, funds available for cash dividend payments by a bank are restricted to the lesser of: (i) retained earnings; or (ii) the bank s net income for its last three fiscal years (less any distributions to shareholders made during such period). However, with the prior approval of the Commissioner of the DFI, a bank may pay cash dividends in an amount not to exceed the greatest of the: (1) retained earnings of the bank; (2) net income of the bank for its last fiscal year; or (3) net income of the bank for its current fiscal year. However, if the DFI finds that the shareholders equity of the bank is not adequate or that the payment of a dividend would be unsafe or unsound, the Commissioner may order the bank not to pay a dividend to shareholders.

Additionally, under FDICIA, a bank may not make any capital distribution, including the payment of dividends, if after making such distribution the bank would be in any of the undercapitalized categories under the FDIC s Prompt Corrective Action regulations. A bank is undercapitalized for this purpose if its leverage ratios, Tier 1 risk-based capital level and total risk-based capital ratio are not at least four percent, four percent and eight percent, respectively.

The FRB, FDIC and the DFI have authority to prohibit a bank holding company or a bank from engaging in practices which are considered to be unsafe and unsound. Depending on the financial condition of the Bank and upon other factors, the FRB, FDIC or the DFI could determine that payment of dividends or other payments by TriCo or the Bank might constitute an unsafe or unsound practice. Finally, any dividend that would cause a bank to fall below required capital levels could also be prohibited.

Source of Strength Doctrine

The Dodd-Frank Act requires a bank holding company to serve as a source of financial strength to its subsidiary banks. Under this source of strength doctrine, a bank holding company is expected to stand ready to use its available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and to maintain resources and the capacity to raise capital that it can commit to its subsidiary banks. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment of deposits and to certain other indebtedness of such subsidiary banks. The BHC Act provides that, in the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment. Furthermore, the FRB has the right to order a bank holding company to terminate any activity that the FRB believes is a serious risk to the financial safety, soundness or stability of any subsidiary bank.

Consumer Protection Laws and Regulations

The Company is subject to many federal consumer protection statues and regulations, some of which are discussed below.

The Community Reinvestment Act of 1977 is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. This act specifically directs the federal regulatory agencies to assess a bank s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound practices. This act further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the Community Reinvestment Act assessment factors in order to provide a rating to the financial institution. The ratings range from a high of outstanding to a low of substantial noncompliance.

The Equal Credit Opportunity Act generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act. The Truth-in-Lending Act is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably.

The Fair Housing Act regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. The Home Mortgage Disclosure Act grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. This act also includes a fair lending aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The Real Estate Settlement Procedures Act requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, this act prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

Penalties under the above laws may include fines, reimbursements, injunctive relief and other penalties.

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USA Patriot Act of 2001

The USA Patriot Act was enacted in 2001 to combat money laundering and terrorist financing. The impact of the Patriot Act on financial institutions is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and requires various regulations, including:

- due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-U.S. persons,
- standards for verifying customer identification at account opening,
- rules to promote cooperation among financial institutions, regulators, and law enforcement entities to assist in the identification of parties that may be involved in terrorism or money laundering,
- reports to be filed by non-financial trades and business with the Treasury Department s Financial Crimes Enforcement Network for transactions exceeding $10,000, and
- the filing of suspicious activities reports by securities brokers and dealers if they believe a customer may be violating U.S. laws and regulations.

Capital Requirements

Federal regulation imposes upon all financial institutions a variable system of risk-based capital guidelines designed to make capital requirements sensitive to differences in risk profiles among banking organizations, to take into account off-balance sheet exposures and to promote uniformity in the definition of bank capital uniform nationally.

The Bank and the Company are subject to the minimum capital requirements of the FDIC and the FRB, respectively. As a result of these requirements, the growth in assets is limited by the amount of its capital as defined by the respective regulatory agency. Capital requirements may have an effect on profitability and the payment of dividends on the common stock of the Bank and the Company. If an entity is unable to increase its assets without violating the minimum capital requirements or is forced to reduce assets, its ability to generate earnings would be reduced.

The FRB and the FDIC have adopted guidelines utilizing a risk-based capital structure. Qualifying capital is divided into two tiers. Tier 1 capital consists generally of common stockholders equity, qualifying noncumulative perpetual preferred stock, qualifying cumulative perpetual preferred stock (up to 25% of total Tier 1 capital) and minority interests in the equity accounts of consolidated subsidiaries, less goodwill and certain other intangible assets. Tier 2 capital consists of, among other things, allowance for loan and lease losses up to 1.25% of weighted risk assets, other perpetual preferred stock, hybrid capital instruments, perpetual debt, mandatory convertible debt securities, subordinated debt and intermediate-term preferred stock. Tier 2 capital qualifies as part of total capital up to a maximum of 100% of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of risk-based capital ratios. Under these risk-based capital guidelines, the Bank and the Company are required to maintain capital equal to at least 8% of its assets, of which at least 4% must be in the form of Tier 1 capital.

The guidelines also require the Company and the Bank to maintain a minimum leverage ratio of 4% of Tier 1 capital to total assets (the leverage ratio). The leverage ratio is determined by dividing an institution s Tier 1 capital by its quarterly average total assets, less goodwill and certain other intangible assets. The leverage ratio constitutes a minimum requirement for the most well-run banking organizations. See Note 19 in the financial statements at Item 8 of this report for a discussion about the Company s risk-based capital and leverage ratios.

Prompt Corrective Action

Prompt Corrective Action Regulations of the federal bank regulatory agencies establish five capital categories in descending order (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized), assignment to which depends upon the institution s total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio. Institutions classified in one of the three undercapitalized categories are subject to certain mandatory and discretionary supervisory actions, which include increased monitoring and review, implementation of capital restoration plans, asset growth restrictions, limitations upon expansion and new business activities, requirements to augment capital, restrictions upon deposit gathering and interest rates, replacement of senior executive officers and directors, and requiring divestiture or sale of the institution. The Bank has been classified as well-capitalized since adoption of these regulations.

Impact of Monetary Policies

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and other borrowings, and the interest rate earned by banks on loans, securities and other interest-earning assets comprises the major source of banks earnings. Thus, the earnings and growth of banks are subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the FRB. The FRB implements national monetary policy, such as seeking to curb inflation and combat recession, by its open-market dealings in United States government securities, by adjusting the required level of reserves for financial institutions subject to reserve requirements and through adjustments to the discount rate applicable to borrowings by banks which are members of the FRB. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits and also affect interest rates. The nature and timing of any future changes in such policies and their impact on the Company cannot be predicted. In addition, adverse economic conditions could make a higher provision for loan losses a prudent course and could cause higher loan loss charge-offs, thus adversely affecting the Company s net earnings.

Premiums for Deposit Insurance

Deposit accounts in the Bank are insured by the FDIC, generally up to a maximum of $250,000 per separately insured depositor. The Bank s deposits are subject to FDIC deposit insurance assessments. The Bank pays insurance assessments based on its consolidated total assets less tangible equity capital. This assessment is based on the risk category of the institution. To determine the total base assessment rate, the FDIC first establishes an institution s initial base assessment rate. This initial base assessment rate ranges, depending on the risk category of the institution, from 5 to 35 basis points. The FDIC then adjusts the initial base assessment based upon an institution s levels of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate ranges from 2.5 to 45 basis points of the institution s average consolidated total assets less tangible equity capital.

In May of 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution s assets minus Tier 1 capital as of June 30, 2009. As a result, the Bank s expense for deposit insurance for the fiscal year ended December 31, 2009 includes approximately $933,000 for this emergency assessment which was levied as of June 30, 2009 and paid on September 30, 2009.

In November of 2009, the FDIC adopted an amendment to its assessment regulations to require insured institutions to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of calendar 2009 and for all of the calendar years 2010, 2011 and 2012. The amount of the prepayment was generally determined based upon an institution s assessment rate in effect on September 30, 2009, adjusted to reflect a 5% growth and as an assessment rate increase of three cents per $100 of deposits effective January 1, 2011. The Bank s prepayment amount was $10,544,000.

The Dodd-Frank Act broadens the base for FDIC insurance assessments and requires the FDIC to revise its regulations so that deposit insurance assessments will be based on the average consolidated total assets less tangible equity capital of a financial institution. Assessment rates on this larger assessment base will initially range from 5 to 35 basis points. After potential adjustment for certain risk elements, the range will be 2.5 to 45 basis points.

On November 21, 2008, the Board of Directors of the FDIC adopted a final rule relating to the Temporary Liquidity Guarantee Program (TLG Program). The TLG Program was intended to counter the system-wide crisis in the nation s financial sector. Under the TLG Program the FDIC (i) guaranteed, through the earlier of maturity or June 30, 2012, certain newly issued senior unsecured debt issued by participating institutions on or after October 14, 2008, and before June 30, 2009 and (ii) provided unlimited FDIC deposit insurance coverage for non-interest bearing transaction deposit accounts, Negotiable Order of Withdrawal (NOW) accounts paying not more than 0.25% interest per annum and Interest on Lawyers Trust Accounts (IOLTA) accounts held at participating FDIC- insured institutions through December 31, 2010. The Dodd-Frank Act extends unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Coverage under the TLG Program was available for the first 30 days without charge. The fee assessment for coverage of senior unsecured debt ranges from 50 basis points to 100 basis points per annum, depending on the initial maturity of the debt. The fee assessment for deposit insurance coverage is 10 basis points per quarter on amounts in covered accounts exceeding $250,000. On December 5, 2008, the Company elected to participate in both guarantee programs. As of December 31, 2011, the Company had issued no debt under the TLG Program.

Securities Laws

The Company is subject to the periodic reporting requirements of the Securities and Exchange Act of 1934, as amended, which include filing annual, quarterly and other current reports with the Securities and Exchange Commission. The Sarbanes-Oxley Act was enacted in 2002 to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws. Among other things, this act:

- prohibits a registered public accounting firm from performing specified nonaudit services contemporaneously with a mandatory audit, requires the chief executive officer and chief financial officer of an issuer to certify each annual or quarterly report filed with the Securities and Exchange Commission,

requires an issuer to disclose all material off-balance sheet transactions that may have a material effect on an issuer s financial status, and

prohibits insider transactions in an issuer s stock during lock-out periods of an issuer s pension plans.

The Company is also required to comply with the rules and regulations of The NASDAQ Stock Market, Inc., on which its common stock is listed.

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ITEM 1A. RISK FACTORS

In analyzing whether to make or continue an investment in the Company, investors should consider, among other factors, the following:

Risks Related to the Nature and Geographic Area of Our Business

The economic downturn in the United States and in California in particular could hurt our profits.

The economies of the United States and California are experiencing an economic slowdown marked by increase unemployment and slower economic growth. Business activity across a wide range of industries and regions is greatly reduced and local governments and many businesses are in serious difficulty due to the lack of consumer spending, declines in the value of real estate and the lack of liquidity in the credit markets. Unemployment has increased significantly.

Since mid-2007, and through 2011, the financial services industry and the securities markets generally were materially and adversely affected by significant declines in the values of nearly all asset classes and by a serious lack of liquidity. This was initially triggered by declines in home prices and the values of subprime mortgages, but spread to all mortgage and real estate asset classes, to leveraged bank loans and to nearly all asset classes, including equities. The global markets have been characterized by substantially increased volatility and short-selling and an overall loss of investor confidence, initially in financial institutions, but more recently in companies in a number of other industries and in the broader markets.

Overall, during 2011, the business environment has been adverse for many households and businesses in California and the United States. There can be no assurance that these conditions will improve in the near term. Such conditions could adversely affect the credit quality of the Company s loans, results of operations and financial condition.

Our business may be adversely affected by business conditions in Northern and Central California.

We conduct most of our business in Northern and Central California. As a result of this geographic concentration, our results are impacted by the difficult economic conditions in California. The current and on-going deterioration in the economic conditions in California could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, results of operations and cash flows:

- problem assets and foreclosures may increase,
- demand for our products and services may decline,
- low cost or non-interest bearing deposits may decrease, and
- collateral for loans made by us, especially real estate, may decline in value, in turn reducing customers borrowing power, and reducing the value of assets and collateral associated with our existing loans.

In view of the concentration of our operations and the collateral securing our loan portfolio in both Northern and Central California, we may be particularly susceptible to the adverse effects of any of these consequences, any of which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We are exposed to risks in connection with the loans we make.

A significant source of risk for us arises from the possibility that we will sustain losses because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. Our earnings are significantly affected by our ability to properly originate, underwrite and service loans. We have underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that we believe to be appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying our respective loan portfolios. Such policies and procedures, however, may not prevent unexpected losses that could adversely affect our results of operations. We could sustain losses if we incorrectly assess the creditworthiness of our borrowers or fail to detect or respond to deterioration in asset quality in a timely manner.

Our allowance for loan losses may not be adequate to cover actual losses.

Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for loan losses reflects our estimate of the probable losses in our loan portfolio at the relevant balance sheet date. Our allowance for loan losses is based on prior experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan portfolio and economic factors. The determination of an appropriate level of loan loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses

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may exceed current estimates. Federal and state regulatory agencies, as an integral part of their examination process, review our loans and allowance for loan losses. While we believe that our allowance for loan losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for loan losses further or that the allowance will be adequate to absorb loan losses we actually incur. Either of these occurrences could have a material adverse affect on our business, financial condition and results of operations.

A significant majority of the loans in our portfolio are secured by real estate and the downturn in our real estate markets could hurt our business.

The downturn in our real estate markets could hurt our business because many of our loans are secured by real estate. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature. As real estate prices decline, the value of real estate collateral securing our loans is reduced. As a result, our ability to recover on defaulted loans by foreclosing and selling the real estate collateral could then be diminished and we would be more likely to suffer losses on defaulted loans. As of December 31, 2011, approximately 88.8% of the book value of our loan portfolio consisted of loans collateralized by various types of real estate. Substantially all of our real estate collateral is located in California. So if there is a significant further decline in real estate values in California, the collateral for our loans will provide less security. Real estate values could also be affected by, among other things, earthquakes and national disasters particular to California in particular. Any such downturn could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We depend on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the California community banking industry. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of our senior management team of Messrs. Smith, O Sullivan, Bailey, Reddish, Carney, Miller and Rios, who have expertise in banking and experience in the California markets we serve and have targeted for future expansion. We also depend upon a number of other key executives who are California natives or are long-time residents and who are integral to implementing our business plan. The loss of the services of any one of our senior executive management team or other key executives could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We are exposed to risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may foreclose and take title to real estate and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean-up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, our business, financial condition, results of operations and cash flows could be materially adversely affected.

Strong competition in California could hurt our profits.

Competition in the banking and financial services industry is intense. Our profitability depends upon our continued ability to successfully compete. We compete exclusively in northern and central California for loans, deposits and customers with commercial banks, savings and loan associations, credit unions, finance companies, mutual funds, insurance companies, and brokerage and investment banking firms. In particular, our competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous locations and mount extensive promotional and advertising campaigns. Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions may have larger lending limits which would allow them to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain loan and deposit customers and a range in quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. We also face competition from out-of-state financial intermediaries that have opened loan production offices or that solicit deposits in our market areas. If we are unable to attract and retain banking customers, we may be unable to continue our loan growth and level of deposits and our business, financial condition, results of operations and cash flows may be adversely affected.

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Our previous results may not be indicative of our future results.

We may not be able to sustain our historical rate of growth and level of profitability or may not even be able to grow our business or continue to be profitable at all. Various factors, such as economic conditions, regulatory and legislative considerations and competition, may also impede or prohibit our ability to expand our market presence and financial performance. If we experience a significant decrease in our historical rate of growth, our results of operations and financial condition may be adversely affected due to a high percentage of our operating costs being fixed expenses.

We may be adversely affected by the soundness of other financial institutions.

Financial services institutions are interrelated as a result of clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. In addition, our credit risk may be exacerbated when the collateral that we hold cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could have a material adverse affect on our financial condition and results of operations.

Recent health care legislation could increase our expenses or require us to pass further costs on to our employees, which could adversely affect our operations, financial condition and earnings.

Legislation enacted in 2010 requires companies to provide expanded health care coverage to their employees, such as affordable coverage to part-time employees and coverage to dependent adult children of employees. Companies will also be required to enroll new employees automatically into their health plans. Compliance with these and other new requirements of the health care legislation will increase our employee benefits expense, and may require us to pass these costs on to our employees, which could give us a competitive disadvantage in hiring and retaining qualified employees.

Market and Interest Rate Risk

Decreasing interest rates could hurt our profits.

Our ability to earn a profit, like that of most financial institutions, depends on our net interest income, which is the difference between the interest income we earn on our interest-earning assets, such as mortgage loans and investments, and the interest expense we pay on our interest-bearing liabilities, such as deposits. Our profitability depends on our ability to manage our assets and liabilities during periods of changing market interest rates. Recently, the FRB has maintained the targeted federal funds rate at record low levels. A sustained decrease in market interest rates could adversely affect our earnings. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans on investment securities. In addition, our commercial real estate and commercial loans, which carry interest rates that adjust in accordance with changes in the prime rate, will adjust to lower rates.

Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.

Because of the differences in the maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread and, in turn, our profitability. In addition, loan origination volumes are affected by market interest rates. Rising interest rates, generally, are associated with a lower volume of loan originations while lower interest rates are usually associated with higher loan originations. Conversely, in rising interest rate environments, loan repayment rates may decline and in falling interest rate environments, loan repayment rates may increase. Although we have been successful in generating new loans during 2011, the continuation of historically low long-term interest rate levels may cause additional refinancing of commercial real estate and 1-4 family residence loans, which may depress our loan volumes or cause rates on loans to decline. In addition, an increase in the general level of short-term interest rates on variable rate loans may adversely affect the ability of certain borrowers to pay the interest on and principal of their obligations or reduce the amount they wish to borrow. Additionally, if short-term market rates rise, in order to retain existing deposit customers and attract new deposit customers we may need to increase rates we pay on deposit accounts. Accordingly, changes in levels of market interest rates could materially and adversely affect our net interest spread, asset quality, loan origination volume, business, financial condition, results of operations and cash flows.

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Regulatory Risks

Recently enacted financial reform legislation will, among other things, create a new Consumer Financial Protection Bureau, tighten capital standards and result in new laws and regulations that are expected to increase our costs of operations.

On July 21, 2010, the President signed the Dodd-Frank Act. This new law significantly changes the current bank regulatory structure and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Among other things, the Dodd-Frank Act creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit unfair, deceptive or abusive acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks such as the Bank with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators. The Dodd-Frank Act also weakens the federal preemption rules that have been applicable for national banks and federal savings associations, and gives state attorneys general the ability to enforce federal consumer protection laws.

The Dodd-Frank Act requires minimum leverage (Tier 1) and risk based capital requirements for bank and savings and loan holding companies that are no less than those applicable to banks, which will exclude certain instruments that previously have been eligible for inclusion by bank holding companies as Tier 1 capital, such as trust preferred securities (unless such securities were issued prior to May 19, 2010 by a bank holding company with less than $15 billion in assets).

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense.

We operate in a highly regulated environment and we may be adversely affected by changes in laws and regulations. Regulations may prevent or impair our ability to pay dividends, engage in acquisitions or operate in other ways.

We are subject to extensive regulation, supervision and examination by the DFI, FDIC, and the FRB. See Item 1 Regulation and Supervision of this report for information on the regulation and supervision which governs our activities. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Banking regulations, designed primarily for the protection of depositors, may limit our growth and the return to you, our investors, by restricting certain of our activities, such as:

- the payment of dividends to our shareholders,
- possible mergers with or acquisitions of or by other institutions,
- desired investments,
- loans and interest rates on loans,
- interest rates paid on deposits,

- the possible expansion of branch offices, and

- the ability to provide securities or trust services.

We also are subject to capitalization guidelines set forth in federal legislation and could be subject to enforcement actions to the extent that we are found by regulatory examiners to be undercapitalized. We cannot predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

Compliance with changing regulation of corporate governance and public disclosure may result in additional risks and expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Dodd-Frank Act, the Sarbanes-Oxley Act of 2002 and new SEC regulations, are creating additional expense for publicly-traded companies such as TriCo. The application of these laws, regulations and standard may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining

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high standards of corporate governance and public disclosure. As a result, our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased expenses and a diversion of management time and attention. In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding management s required assessment of its internal control over financial reporting and its external auditors audit of that assessment has required the commitment of significant financial and managerial resources. We expect these efforts to require the continued commitment of significant resources. Further, the members of our board of directors, members of our audit or compensation and management succession committees, our chief executive officer, our chief financial officer and certain other executive officers could face an increased risk of personal liability in connection with the performance of their duties. It may also become more difficult and more expensive to obtain director and officer liability insurance. As a result, our ability to attract and retain executive officers and qualified board and committee members could be more difficult.

We could be aversely affected by new regulations.

Federal and state governments and regulators could pass legislation and adopt policies responsive to current credit conditions that would have an adverse affect on the Company and its financial performance. For example, the Company could experience higher credit losses because of federal or state legislation or regulatory action that limits the Bank s ability to foreclose on property or other collateral or makes foreclosure less economically feasible.

We could face increased deposit insurance costs.

The FDIC insures deposits at FDIC insured financial institutions up to certain limits. The FDIC charges insured financial institutions premiums to maintain the Deposit Insurance Fund. If the Deposit Insurance Fund suffers further losses, the FDIC could increase assessments rates or impose additional special assessments on the banking industry to replenish the Deposit Insurance Fund. The Company s profitability could be reduced by any increase in assessment rates or special assessments.

Risks Related to Growth and Expansion

If we cannot attract deposits, our growth may be inhibited.

We plan to increase the level of our assets, including our loan portfolio. Our ability to increase our assets depends in large part on our ability to attract additional deposits at favorable rates. We intend to seek additional deposits by offering deposit products that are competitive with those offered by other financial institutions in our markets and by establishing personal relationships with our customers. We cannot assure you that these efforts will be successful. Our inability to attract additional deposits at competitive rates could have a material adverse effect on our business, financial condition, results of operations and cash flows.

There are potential risks associated with future acquisitions and expansions.

We intend to continue to explore expanding our branch system through opening new bank branches and in-store branches in existing or new markets in northern and central California. In the ordinary course of business, we evaluate potential branch locations that would bolster our ability to cater to the small business, individual and residential lending markets in California. Any given new branch, if and when opened, will have expenses in excess of revenues for varying periods after opening that may adversely affect our results of operations or overall financial condition.

In addition, to the extent that we acquire other banks in the future, our business may be negatively impacted by certain risks inherent with such acquisitions. These risks include:

- incurring substantial expenses in pursuing potential acquisitions without completing such acquisitions,
- losing key clients as a result of the change of ownership,
- the acquired business not performing in accordance with our expectations,

difficulties arising in connection with the integration of the operations of the acquired business with our operations,

needing to make significant investments and infrastructure, controls, staff, emergency backup facilities or other critical business functions that become strained by our growth,

management needing to divert attention from other aspects of our business,

potentially losing key employees of the acquired business,

incurring unanticipated costs which could reduce our earnings per share,

assuming potential liabilities of the acquired company as a result of the acquisition, and

an acquisition may dilute our earnings per share, in both the short and long term, or it may reduce our tangible capital ratios.

As result of these risks, any given acquisition, if and when consummated, may adversely affect our results of operations or financial condition. In addition, because the consideration for an acquisition may involve cash, debt or the issuance of shares of our stock and may involve the payment of a premium over book and market values, existing shareholders may experience dilution in connection with any acquisition.

Our growth and expansion may strain our ability to manage our operations and our financial resources.

Our financial performance and profitability depend on our ability to execute our corporate growth strategy. In addition to seeking deposit and loan and lease growth in our existing markets, we may pursue expansion opportunities in new markets. Continued growth, however, may present operating and other problems that could adversely affect our business, financial condition, results of operations and cash flows. Accordingly, there can be no assurance that we will be able to execute our growth strategy or maintain the level of profitability that we have recently experienced.

Our growth may place a strain on our administrative, operational and financial resources and increase demands on our systems and controls. This business growth may require continued enhancements to and expansion of our operating and financial systems and controls and may strain or significantly challenge them. In addition, our existing operating and financial control systems and infrastructure may not be adequate to maintain and effectively monitor future growth. Our continued growth may also increase our need for qualified personnel. We cannot assure you that we will be successful in attracting, integrating and retaining such personnel.

Our decisions regarding the fair value of assets acquired from Citizens and Granite, including the FDIC loss sharing assets associated with Granite, could be inaccurate which could materially and adversely affect our business, financial condition, results of operations, and future prospects.

Management makes various assumptions and judgments about the collectability of acquired loans, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of secured loans. In FDIC-assisted acquisitions that include loss sharing agreements, such as our acquisition of Granite, we may record a loss sharing asset that we consider adequate to absorb future losses which may occur in the acquired loan portfolio. In determining the size of the loss sharing asset, we analyze the loan portfolio based on historical loss experience, volume and classification of loans, volume and trends in delinquencies and nonaccruals, local economic conditions, and other pertinent information.

If our assumptions are incorrect, the balance of the FDIC indemnification asset may at any time be insufficient to cover future loan losses, and credit loss provisions may be needed to respond to different economic conditions or adverse developments in the acquired loan portfolio. Any increase in future loan losses could have a negative effect on our operating results.

Our ability to obtain reimbursement under the loss sharing agreement on covered assets purchased from the FDIC depends on our compliance with the terms of the loss sharing agreement.

We must certify to the FDIC on a quarterly basis our compliance with the terms of the FDIC loss sharing agreement as a prerequisite to obtaining reimbursement from the FDIC for realized losses on covered assets. The required terms of the agreements are extensive and failure to comply with any of the guidelines could result in a specific asset or group of assets permanently losing their loss sharing coverage. Additionally, Management may decide to forgo loss share coverage on certain assets to allow greater flexibility over the management of certain assets. As of December 31, 2011, $52,135,000, or 2.0%, of the Company s assets were covered by the aforementioned FDIC loss sharing agreements.

Risks Relating to Dividends and Our Common Stock

Our future ability to pay dividends is subject to restrictions.

Since we are a holding company with no significant assets other than the Bank, we currently depend upon dividends from the Bank for a substantial portion of our revenues. Our ability to continue to pay dividends in the future will continue to depend in large part upon our receipt of dividends or other capital distributions from the Bank. The ability of the Bank to pay dividends or make other capital distributions to us is subject to the restrictions in the California Financial Code and the regulatory authority of the DFI. As of December 31, 2011, the Bank could have paid $14,073,000 in dividends without the prior approval of the DFI. The amount that the Bank may pay in dividends is further restricted due to the fact that the Bank must maintain a certain minimum amount of capital to be considered a well capitalized institution as further described under Item 1 Capital Requirements in this report.

From time to time, we may become a party to financing agreements or other contractual arrangements that have the effect of limiting or prohibiting us or the Bank from declaring or paying dividends. Our holding company expenses and obligations with respect to our trust preferred securities and corresponding junior subordinated deferrable interest debentures issued by us may limit or impair our ability to declare or pay dividends. Finally, our ability to pay dividends is also subject to the restrictions of the California Corporations Code. See Regulation and Supervision Restrictions on Dividends and Distributions .

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Only a limited trading market exists for our common stock, which could lead to price volatility.

Our common stock is quoted on the NASDAQ Global Select Market and trading volumes have been modest. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market of our common stock. In addition, even if a more active market in our common stock develops, we cannot assure you that such a market will continue or that shareholders will be able to sell their shares.

Anti-takeover provisions and federal law may limit the ability of another party to acquire us, which could cause our stock price to decline.

Various provisions of our articles of incorporation and bylaws could delay or prevent a third party from acquiring us, even if doing so might be beneficial to our shareholders. These provisions provide for, among other things:

- specified actions that the Board of Directors shall or may take when an offer to merge, an offer to acquire all assets or a tender offer is received,
- a shareholder rights plan which could deter a tender offer by requiring a potential acquiror to pay a substantial premium over the market price of our common stock,
- advance notice requirements for proposals that can be acted upon at shareholder meetings, and
- the authorization to issue preferred stock by action of the board of directors acting alone, thus without obtaining shareholder approval.

The Bank Holding Company Act of 1956, as amended, and the Change in Bank Control Act of 1978, as amended, together with federal regulations, require that, depending on the particular circumstances, either FRB approval must be obtained or notice must be furnished to the FRB and not disapproved prior to any person or entity acquiring control of a bank holding company such as TriCo. These provisions may prevent a merger or acquisition that would be attractive to shareholders and could limit the price investors would be willing to pay in the future for our common stock.

The amount of common stock owned by, and other compensation arrangements with, our officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose.

As of March 2, 2012, directors and executive officers beneficially owned approximately 15.83% of our common stock and our ESOP owned approximately 8.48%. Agreements with our senior management also provide for significant payments under certain circumstances following a change in control. These compensation arrangements, together with the common stock and option ownership of our board of directors and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals of us that our directors and officers oppose.

We may issue additional common stock or other equity securities in the future which could dilute the ownership interest of existing shareholders.

In order to maintain our capital at desired or regulatorily-required levels, or to fund future growth, our board of directors may decide from time to time to issue additional shares of common stock, or securities convertible into, exchangeable for or representing rights to acquire shares of our common stock. The sale of these shares may significantly dilute your ownership interest as a shareholder. New investors in the future may also have rights, preferences and privileges senior to our current shareholders which may adversely impact our current shareholders.

Holders of our junior subordinated debentures have rights that are senior to those of our common stockholders.

We have supported our continued growth through the issuance of trust preferred securities from special purpose trusts and accompanying junior subordinated debentures. At December 31, 2011, we had outstanding trust preferred securities and accompanying junior subordinated debentures totaling $41,238,000. Payments of the principal and interest on the trust preferred securities are conditionally guaranteed by us. Further, the accompanying junior subordinated debentures we issued to the trusts are senior to our shares of common stock. As a result, we must make payments on the junior subordinated debentures before any dividends can be paid on our common stock and, in the event of our bankruptcy, dissolution or liquidation, the holders of the junior subordinated debentures must be satisfied before any distributions can be made on our common stock.

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Risks Relating to Systems, Accounting and Internal Controls

If we fail to maintain an effective system of internal and disclosure controls, we may not be able to accurately report our financial results or prevent fraud. As a result, current and potential shareholders could lose confidence in our financial reporting, which would harm our business and the trading price of our securities.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. If we cannot provide reliable financial reports or prevent fraud, our reputation and operating results would be harmed. We continually review and analyze our internal control over financial reporting for Sarbanes-Oxley Section 404 compliance. As part of that process we may discover material weaknesses or significant deficiencies in our internal control as defined under standards adopted by the Public Company Accounting Oversight Board that require remediation. Material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected in a timely basis. Significant deficiency is a deficiency or combination of deficiencies, in internal control over financial reporting that is less severe than material weakness, yet important enough to merit attention by those responsible for the oversight of the Company s financial reporting.

As a result of weaknesses that may be identified in our internal control, we may also identify certain deficiencies in some of our disclosure controls and procedures that we believe require remediation. If we discover weaknesses, we will make efforts to improve our internal and disclosure control. However, there is no assurance that we will be successful. Any failure to maintain effective controls or timely effect any necessary improvement of our internal and disclosure controls could harm operating results or cause us to fail to meet our reporting obligations, which could affect our ability to remain listed with The NASDAQ Global Select Market. Ineffective internal and disclosure controls could also cause investors to lose confidence in our reported financial information, which would likely have a negative effect on the trading price of our securities.

We rely on communications, information, operating and financial control systems technology and we may suffer an interruption in or breach of the security of those systems.

We rely heavily on our communications, information, operating and financial control systems technology to conduct our business. We rely on third party services providers to provide many of these systems. Any failure, interruption or breach in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and loan origination systems. We cannot assure you that such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed by us or the third parties service providers on which we rely. The occurrence of any failures, interruptions or security breaches could damage our reputation, result in a loss of customers, expose us to possible financial liability, lead to additional regulatory scrutiny or require that we make expenditures for remediation or prevention. Any of these circumstances could have a material adverse effect on our business, financial condition, results of operations and cash flows.

A failure to implement technological advances could negatively impact our business.

The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources than we do to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or successfully market such products and services to our customers.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

The Company is engaged in the banking business through 68 offices in 23 counties in Northern and Central California including ten offices in Shasta County, nine in Butte County, seven in Sacramento and Nevada Counties, six in Placer County, four in Stanislaus County, three each in Siskiyou, Sutter and Kern Counties, two each in Glenn and Yolo Counties, and one each in Contra Costa, Del Norte, Fresno, Lake, Lassen, Madera, Mendocino, Merced, Napa, Tehama, Tulare, and Yuba Counties. All offices are constructed and equipped to meet prescribed security requirements.

The Company owns eighteen branch office locations, four administrative buildings, and one other building that it leases out. The Company leases fifty branch office locations, and three administrative buildings. Most of the leases contain multiple renewal options and provisions for rental increases, principally for changes in the cost of living index, property taxes and maintenance.

ITEM 3. LEGAL PROCEEDINGS

Neither the Company nor its subsidiaries, are party to any material pending legal proceeding, nor is their property the subject of any material pending legal proceeding, except routine legal proceedings arising in the ordinary course of their business. None of these proceedings is expected to have a material adverse impact upon the Company s business, consolidated financial position or results of operations.

ITEM 4. MINE SAFETY DISCLOSURES

Inapplicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Common Stock Market Prices and Dividends

The Company s common stock is traded on the NASDAQ Global Select Market System (NASDAQ) under the symbol TCBK. The following table shows the high and the low closing sale prices for the common stock for each quarter in the past two years, as reported by NASDAQ:

2011:	High	Low
Fourth quarter	$ 15.32	$ 11.58
Third quarter	$ 15.50	$ 11.75
Second quarter	$ 16.58	$ 13.18
First quarter	$ 16.76	$ 14.53
2010:		
Fourth quarter	$ 16.59	$ 14.21
Third quarter	$ 18.99	$ 13.46
Second quarter	$ 22.99	$ 16.93
First quarter	$ 20.73	$ 16.65

As of March 2, 2012 there were approximately 1,509 shareholders of record of the Company s common stock. On March 2, 2012, the closing sales price was $15.64.

The Company has paid cash dividends on its common stock in every quarter since March 1990, and it is currently the intention of the Board of Directors of the Company to continue payment of cash dividends on a quarterly basis. There is no assurance, however, that any dividends will be paid since they are dependent upon earnings, financial condition and capital requirements of the Company and the Bank. As of December 31, 2011, $14,073,000 was available for payment of dividends by the Company to its shareholders, under applicable laws and regulations. The Company paid cash dividends of $0.09 per common share in each of the quarters ended December 31, 2011, September 30, 2011, June 30, 2011, and March 31, 2011, December 31, 2010, September 30, 2010 and June 30, 2010 and $0.13 per common share in the quarter ended March 31, 2010.

Stock Repurchase Plan

The Company adopted a stock repurchase plan on August 21, 2007 for the repurchase of up to 500,000 shares of the Company s common stock from time to time as market conditions allow. The 500,000 shares authorized for repurchase under this plan represented approximately 3.2% of the Company s approximately 15,815,000 common shares outstanding as of August 21, 2007. This plan has no stated expiration date for the repurchases. As of December 31, 2011, the Company had purchased 166,600 shares under this plan. The following table shows the repurchases made by the Company or any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Exchange Act) during the fourth quarter of 2011:

Period	(a) Total number of shares purchased	(b) Average price paid per share	(c) Total number of shares purchased as part of publicly announced plans or programs	(d) Maximum number of shares that may yet be purchased under the plans or programs
Oct. 1-31, 2011				333,400
Nov. 1-30, 2011				333,400
Dec. 1-31, 2011				333,400
Total				333,400

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The following graph presents the cumulative total yearly shareholder return from investing $100 on December 31, 2006, in each of TriCo common stock, the Russell 3000 Index, and the SNL Western Bank Index. The SNL Western Bank Index compiled by SNL Financial includes banks located in California, Oregon, Washington, Montana, Hawaii and Alaska with market capitalization similar to that of TriCo s. The amounts shown assume that any dividends were reinvested.

TriCo Bancshares

	Period Ending					
Index	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**
TriCo Bancshares	100.00	72.59	96.64	66.58	66.16	59.77
Russell 3000	100.00	105.14	65.92	84.60	98.92	99.93
SNL Western Bank	100.00	83.53	81.33	74.68	84.62	76.45

Equity Compensation Plans

The following table shows shares reserved for issuance for outstanding options, stock appreciation rights and warrants granted under our equity compensation plans as of December 31, 2011. All of our equity compensation plans have been approved by shareholders.

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans not approved by shareholders			
Equity compensation plans approved by shareholders	1,250,935	$ 17.18	251,000
Total	1,250,935	$ 17.18	251,000

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data are derived from our consolidated financial statements. This data should be read in connection with our consolidated financial statements and the related notes located at Item 8 of this report.

TRICO BANCSHARES

Financial Summary

(in thousands, except per share amounts)

Year ended December 31,	2011	2010	2009	2008	2007
Interest income	$ 102,982	$ 104,572	$ 112,333	$ 121,112	$ 127,268
Interest expense	10,238	14,133	20,615	31,552	40,582
Net interest income	92,744	90,439	91,718	89,560	86,686
Provision for loan losses	23,060	37,458	31,450	20,950	3,032
Noninterest income	42,813	32,695	30,329	27,087	27,590
Noninterest expense	82,715	77,205	75,450	68,738	68,906
Income before income taxes	29,782	8,471	15,147	26,959	42,338
Provision for income taxes	11,192	2,466	5,185	10,161	16,645
Net income	$ 18,590	$ 6,005	$ 9,962	$ 16,798	$ 25,693
Earnings per share:					
Basic	$ 1.17	$ 0.38	$ 0.63	$ 1.07	$ 1.62
Diluted	$ 1.16	$ 0.37	$ 0.62	$ 1.05	$ 1.57
Per share:					
Dividends paid	$ 0.36	$ 0.40	$ 0.52	$ 0.52	$ 0.52
Book value at December 31	$ 13.55	$ 12.64	$ 12.71	$ 12.56	$ 11.87
Tangible book value at December 31	$ 12.49	$ 11.62	$ 11.71	$ 11.54	$ 10.82
Average common shares outstanding	15,935	15,860	15,783	15,771	15,898
Average diluted common shares outstanding	16,000	16,010	16,011	16,050	16,364
Shares outstanding at December 31	15,979	15,860	15,787	15,756	15,912
At December 31:					
Loans, net	$ 1,505,118	$ 1,377,000	$ 1,460,097	$ 1,563,259	$ 1,534,635
Total assets	2,555,597	2,189,789	2,170,520	2,043,190	1,980,621
Total deposits	2,190,536	1,852,173	1,828,512	1,669,270	1,545,223
Debt financing and notes payable	72,541	62,020	66,753	102,005	116,126
Junior subordinated debt	41,238	41,238	41,238	41,238	41,238
Shareholders equity	216,441	200,397	200,649	197,932	188,878
Financial Ratios:					
For the year:					
Return on assets	0.82%	0.27%	0.48%	0.85%	1.36%
Return on equity	8.93%	2.94%	4.89%	8.70%	14.20%
Net interest margin[1]	4.43%	4.45%	4.77%	4.96%	5.07%
Net loan losses to average loans	1.37%	2.07%	1.53%	0.69%	0.17%
Efficiency ratio[1]	60.88%	62.49%	61.53%	58.59%	59.86%
Average equity to average assets	9.15%	9.25%	9.73%	9.72%	9.55%
At December 31:					
Equity to assets	8.47%	9.15%	9.24%	9.69%	9.54%
Total capital to risk-adjusted assets	13.94%	14.20%	13.36%	12.42%	11.90%
Allowance for loan losses to loans	2.96%	3.00%	2.37%	1.73%	1.12%

[1] Fully taxable equivalent

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

As TriCo Bancshares (referred to in this report as we , our or the Company) has not commenced any business operations independent of Tri Counties Bank (the Bank), the following discussion pertains primarily to the Bank. Average balances, including such balances used in calculating certain financial ratios, are generally comprised of average daily balances for the Company. Within Management s Discussion and Analysis of Financial Condition and Results of Operations, interest income and net interest income are generally presented on a fully tax-equivalent (FTE) basis. The presentation of interest income and net interest income on a FTE basis is a common practice within the banking industry. Interest income and net interest income are shown on a non-FTE basis in the Part I Financial Information section of this Form 10-Q, and a reconciliation of the FTE and non-FTE presentations is provided below in the discussion of net interest income.

Critical Accounting Policies and Estimates

The Company s discussion and analysis of its financial condition and results of operations are based upon the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those that materially affect the financial statements and are related to the adequacy of the allowance for loan losses, investments, mortgage servicing rights, fair value measurements, retirement plans and intangible assets. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company s policies related to estimates on the allowance for loan losses, other than temporary impairment of investments and impairment of intangible assets, can be found in Note 1 in the financial statements at Item 8 of this report.

As the Company has not commenced any business operations independent of the Bank, the following discussion pertains primarily to the Bank. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances for the Company. Within Management s Discussion and Analysis of Financial Condition and Results of Operations, certain performance measures including interest income, net interest income, net interest yield, and efficiency ratio are generally presented on a fully tax-equivalent (FTE) basis. The Company believes the use of these non-generally accepted accounting principles (non-GAAP) measures provides additional clarity in assessing its results.

On September 23, 2011, the California Department of Financial Institutions closed Citizens Bank of Northern California (Citizens), Nevada City, California and appointed the FDIC as receiver. That same date, the Bank assumed the banking operations of Citizens from the FDIC under a whole bank purchase and assumption agreement without loss sharing. With this agreement, the Bank added seven traditional bank branches including two in Grass Valley, and one in each of Nevada City, Penn Valley, Lake of the Pines, Truckee, and Auburn, California. This acquisition is consistent with the Bank s community banking expansion strategy and provides further opportunity to fill in the Bank s market presence in the Northern California market.

On May 28, 2010, the Office of the Comptroller of the Currency closed Granite Community Bank (Granite), Granite Bay, California and appointed the FDIC as receiver. That same date, the Bank assumed the banking operations of Granite from the FDIC under a whole bank purchase and assumption agreement with loss sharing. Under the terms of the loss sharing agreement, the FDIC will cover a substantial portion of any future losses on loans, related unfunded loan commitments, other real estate owned (OREO)/foreclosed assets and accrued interest on loans for up to 90 days. The FDIC will absorb 80% of losses and share in 80% of loss recoveries on the covered assets acquired from Granite. The loss sharing arrangements for non-single family residential and single family residential loans are in effect for 5 years and 10 years, respectively, and the loss recovery provisions are in effect for 8 years and 10 years, respectively, from the acquisition date. With this agreement, the Bank added one traditional bank branch in each of Granite Bay and Auburn, California. This acquisition is consistent with the Bank s community banking expansion strategy and provides further opportunity to fill in the Bank s market presence in the greater Sacramento, California market.

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The Company refers to loans and foreclosed assets that are covered by loss sharing agreements as covered loans and covered foreclosed assets , respectively. In addition, the Company refers to loans purchased or obtained in a business combination as purchased credit impaired (PCI) loans, or purchased non-credit impaired (PNCI) loans. The Company refers to loans that it originates as originated loans. Additional information regarding the Citizens and Granite Bank acquisitions can be found in Note 2 in the financial statements at Item 8 of this report. Additional information regarding the definitions and accounting for originated, PNCI and PCI loans can be found in Notes 1, 2, 4 and 5 in the financial statements at Item 8 of this report, and under the heading *Asset Quality and Non-Performing Assets* below.

Geographical Descriptions

For the purpose of describing the geographical location of the Company s loans, the Company has defined northern California as that area of California north of, and including, Stockton; central California as that area of the State south of Stockton, to and including, Bakersfield; and southern California as that area of the State south of Bakersfield.

Results of Operations

Overview

The following discussion and analysis is designed to provide a better understanding of the significant changes and trends related to the Company and the Bank s financial condition, operating results, asset and liability management, liquidity and capital resources and should be read in conjunction with the consolidated financial statements of the Company and the related notes at Item 8 of this report.

Following is a summary of the components of net income for the periods indicated (dollars in thousands):

	Year ended December 31,		
	2011	2010	2009
Components of Net Income			
Net interest income	$ 92,744	$ 90,439	$ 91,718
Provision for loan losses	(23,060)	(37,458)	(31,450)
Noninterest income	42,813	32,695	30,329
Noninterest expense	(82,715)	(77,205)	(75,450)
Taxes	(11,192)	(2,466)	(5,185)
Net income	$ 18,590	$ 6,005	$ 9,962
Net income per average fully-diluted share	$ 1.16	$ 0.37	$ 0.62
Net income as a percentage of average shareholders equity	8.93%	2.94%	4.89%
Net income as a percentage of average total assets	0.82%	0.27%	0.48%

Net Interest Income

The Company s primary source of revenue is net interest income, which is the difference between interest income on earning assets and interest expense on interest-bearing liabilities.

Following is a summary of the Company s net interest income for the periods indicated (dollars in thousands):

	Year ended December 31,		
	2011	2010	2009
Components of Net Interest Income			
Interest income	$ 102,982	$ 104,572	$ 112,333
Interest expense	(10,238)	(14,133)	(20,615)

Net interest income	92,744	90,439	91,718
FTE adjustment	309	413	572
Net interest income (FTE)	$ 93,053	$ 90,852	$ 92,290
Net interest margin (FTE)	4.43%	4.45%	4.77%

Net interest income (FTE) for the year ended December 31, 2011 was $93,053,000, an increase of $2,201,000 or 2.4% compared to the year ended December 31, 2010. The increase in net interest income during 2011 when compared to 2010 is mainly due to the acquisition of Citizens on September 23, 2011 and its associated net interest income of $6,117,000 from September 23, 2011 to December 31, 2011. Included in the net interest income associated with the Citizens acquisition is $3,146,000 from the accretion of loan purchase discounts. Also contributing to the increase in net interest income was a reduction in deposit rates and the flow of deposits from relatively higher paying time deposits to lower paying non-maturity deposits. Partially offsetting the increase in net interest income related to the Citizens acquisition and the deposit rate and volume changes were organic loan payoffs in excess of loan production during 2011. These loan payoffs in excess of loan production and deposit growth during 2011 were deployed into lower yielding short-term interest-earning balances at the Federal Reserve Bank. During 2011, investment opportunities continued to be unattractive given their low market yields and interest rate risk profile.

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Net interest income (FTE) for the year ended December 31, 2010 was $90,852,000, a decrease of $1,438,000 or 1.6% compared to the year ended December 31, 2009. This decrease in net interest income was attributable to a change in the mix of interest-earning assets, with average loan balances decreasing and other categories of lower yielding assets increasing. The decrease in average loan balances was due to decreased loan demand and unfavorable credit risks associated with loans in the economic environment that persisted throughout 2010. While the Company was able to continue to lower interest-bearing liability rates, and thus interest expense, sufficiently to overcome the decrease in interest income due to decreases in the average yield on interest-earning assets during 2010, it was not sufficient to overcome the decrease in average loan balances during 2010. The Yield and Volume/Rate tables shown below are useful in illustrating and quantifying the developments that affected net interest income during 2010.

Summary of Average Balances, Yields/Rates and Interest Differential Yield Tables

The following tables present, for the periods indicated, information regarding the Company s consolidated average assets, liabilities and shareholders equity, the amounts of interest income from average earning assets and resulting yields, and the amount of interest expense paid on interest-bearing liabilities. Average loan balances include nonperforming loans. Interest income includes proceeds from loans on nonaccrual loans only to the extent cash payments have been received and applied to interest income. Yields on securities and certain loans have been adjusted upward to reflect the effect of income thereon exempt from federal income taxation at the current statutory tax rate (dollars in thousands):

	Year ended December 31, 2011		
	Average balance	Interest income/expense	Rates earned/paid
Assets			
Loans	$ 1,442,821	$ 92,691	6.42%
Investment securities taxable	262,306	8,760	3.34%
Investment securities nontaxable	11,403	833	7.31%
Cash at Federal Reserve and other banks	386,067	1,007	0.26%
Total earning assets	2,102,597	103,291	4.91%
Other assets	173,311		
Total assets	$ 2,275,908		
Liabilities and shareholders equity			
Interest-bearing demand deposits	$ 410,870	$ 1,217	0.30%
Savings deposits	661,480	1,421	0.21%
Time deposits	415,319	3,921	0.94%
Other borrowings	63,602	2,420	3.80%
Junior subordinated debt	41,238	1,259	3.05%
Total interest-bearing liabilities	1,592,509	10,238	0.64%
Noninterest-bearing demand	442,174		
Other liabilities	33,005		
Shareholders equity	208,220		
Total liabilities and shareholders equity	$ 2,275,908		
Net interest spread (1)			4.27%
Net interest income and interest margin (2)		$ 93,053	4.43%

(1) Net interest spread represents the average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.
(2) Net interest margin is computed by dividing net interest income by total average earning assets.

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Summary of Average Balances, Yields/Rates and Interest Differential Yield Tables (continued)

	Year ended December 31, 2010		
	Average balance	Interest income/expense	Rates earned/paid
Assets			
Loans	$ 1,464,606	$ 93,073	6.35%
Investment securities taxable	263,059	10,039	3.82%
Investment securities nontaxable	14,717	1,113	7.56%
Cash at Federal Reserve and other banks	296,970	760	0.26%
Total earning assets	2,039,352	104,985	5.15%
Other assets	169,290		
Total assets	$ 2,208,642		
Liabilities and shareholders equity			
Interest-bearing demand deposits	$ 384,077	2,242	0.58%
Savings deposits	552,104	2,277	0.41%
Time deposits	544,018	5,928	1.09%
Other borrowings	62,110	2,412	3.88%
Junior subordinated debt	41,238	1,274	3.09%
Total interest-bearing liabilities	1,583,547	14,133	0.89%
Noninterest-bearing demand	385,704		
Other liabilities	35,196		
Shareholders equity	204,195		
Total liabilities and shareholders equity	$ 2,208,642		
Net interest spread (1)			4.26%
Net interest income and interest margin (2)		$ 90,852	4.45%

	Year ended December 31, 2009		
	Average balance	Interest income/expense	Rates earned/paid
Assets			
Loans	$ 1,542,147	$ 99,996	6.48%
Investment securities taxable	232,636	11,019	4.74%
Investment securities nontaxable	20,782	1,558	7.50%
Cash at Federal Reserve and other banks	141,172	332	0.24%
Total earning assets	1,936,717	112,905	5.83%
Other assets	156,551		
Total assets	$ 2,093,268		
Liabilities and shareholders equity			

Interest-bearing demand deposits	$ 296,997	2,060	0.69%
Savings deposits	444,105	3,166	0.71%
Time deposits	637,480	12,665	1.99%
Other borrowings	73,121	1,221	1.67%
Junior subordinated debt	41,238	1,503	3.64%
Total interest-bearing liabilities	1,492,941	20,615	1.38%
Noninterest-bearing demand	359,693		
Other liabilities	37,025		
Shareholders equity	203,609		
Total liabilities and shareholders equity	$ 2,093,268		
Net interest spread (1)			4.45%
Net interest income and interest margin (2)		$ 92,290	4.77%

(1) Net interest spread represents the average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.
(2) Net interest margin is computed by dividing net interest income by total average earning assets.

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Summary of Changes in Interest Income and Expense due to Changes in Average Asset and Liability Balances and Yields Earned and Rates Paid Volume/Rate Tables

The following table sets forth a summary of the changes in the Company s interest income and interest expense from changes in average asset and liability balances (volume) and changes in average interest rates for the periods indicated. The rate/volume variance has been included in the rate variance. Amounts are calculated on a fully taxable equivalent basis:

	2011 over 2010			2010 over 2009		
	Volume	Yield/ Rate	Total	Volume	Yield/ Rate	Total
			(dollars in thousands)			
Increase (decrease) in interest income:						
Loans	$ (1,383)	$ 1,001	$ (382)	$ (5,025)	$ (1,898)	$ (6,923)
Investments taxable	(29)	(1,250)	(1,279)	1,442	(2,422)	(980)
Investments nontaxable	(251)	(29)	(280)	(455)	10	(445)
Cash at Federal Reserve and other banks	232	15	247	374	54	428
Total	(1,431)	(263)	(1,694)	(3,664)	(4,256)	(7,920)
Increase (decrease) in interest expense:						
Demand deposits (interest-bearing)	155	(1,180)	(1,025)	601	(419)	182
Savings deposits	448	(1,304)	(856)	767	(1,656)	(889)
Time deposits	(1,403)	(604)	(2,007)	(1,860)	(4,877)	(6,737)
Other borrowings	58	(50)	8	(184)	1,375	1,191
Junior subordinated debt		(15)	(15)		(229)	(229)
Total	(742)	(3,153)	(3,895)	(676)	(5,806)	(6,482)
Increase (decrease) in net interest income	$ (689)	$ 2,890	$ 2,201	$ (2,988)	$ 1,550	$ (1,438)

Provision for Loan Losses

The provision for loan losses was $23,060,000 and $37,458,000 for the years ended December 31, 2011, and 2010, respectively. The decreases in the provision for loan losses for the year ended December 31, 2011 as compared to the year ended December 31, 2010 was primarily the result of changes in the make-up of the originated loan portfolio and the Bank s loss factors related to the originated loan portfolio in reaction to decreased losses in the construction, commercial real estate, commercial & industrial (C&I), home equity and auto indirect loan portfolios. Included in the provision for loan losses for the year ended December 31, 2011 is $1,562,000 related to loans acquired in the Citizens acquisition and $1,248,000 related to loans acquired in the Granite acquisition.

The provision for loan losses was $37,458,000 and $31,450,000 for the years ended December 31, 2010, and 2009, respectively. The increases in the provision for loan losses for the year ended December 31, 2010 as compared to the year ended December 31, 2009 was primarily the result of changes in the make-up of the originated loan portfolio and the Bank s loss factors related to the originated loan portfolio in reaction to increased losses in the construction, commercial real estate, commercial & industrial (C&I), home equity and auto indirect loan portfolios, and decreases in expected cash flows of certain PCI loan pools. Included in the provision for loan losses for the year ended December 31, 2010 is $1,608,000 related to loans acquired in the Granite acquisition on May 28, 2010. Prior to May 28, 2010, the Company had no PCI loans.

Management re-evaluates the loss ratios and assumptions of its originated and PNCI loan portfolios and makes changes as appropriate based upon, among other things, changes in loss rates experienced, collateral support for underlying loans, changes and trends in the economy, and changes in the loan mix. Management also re-evaluates expected cash flows for its PCI loan portfolio quarterly and makes changes as appropriate based upon, among other things, changes in loan repayment experience, changes in loss rates experienced, and collateral support for underlying loans.

The provision for loan losses related to originated and PNCI loans is based on management s evaluation of inherent risks in these loan portfolios and a corresponding analysis of the allowance for loan losses. The provision for loan losses related to PCI loan portfolio is based on changes in estimated cash flows expected to be collected on PCI loans. Additional discussion on loan quality, our procedures to measure loan impairment, and the allowance for loan losses is provided under the heading *Asset Quality and Non-Performing Assets* below.

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Noninterest Income

The following table summarizes the Company s noninterest income for the periods indicated (dollars in thousands):

	Year ended December 31, 2011	2010	2009
Components of Noninterest Income			
Service charges on deposit accounts	$ 14,776	$ 15,296	$ 16,080
ATM fees and interchange	7,058	6,078	4,925
Other service fees	1,722	1,452	1,229
Mortgage banking service fees	1,495	1,303	1,140
Change in value of mortgage servicing rights	(1,107)	(1,029)	(552)
Total service charges and fees	23,944	23,100	22,822
Gain on sale of loans	3,037	3,647	3,466
Commissions on sale of nondeposit investment products	2,105	1,209	1,632
Increase in cash value of life insurance	1,885	1,847	1,879
Change in indemnification asset	2,059	1,274	
Gain on disposition of foreclosed assets	680	562	168
Legal settlement		400	
Bargain purchase gain	7,575	232	
Gain on life insurance death benefit	789		
Other noninterest income	739	424	362
Total noninterest income	$ 42,813	$ 32,695	$ 30,329

Noninterest income increased $10,118,000 (30.9%) to $42,813,000 in 2011. Service charges on deposit accounts were down $520,000 (3.4%) due to new overdraft regulations that became effective on July 1, 2010 and caused a decrease in non-sufficient funds fees. ATM fees and interchange income was up $980,000 (16.1%) due to increased customer point-of-sale transactions that are the result of incentives for such usage. Overall, mortgage banking activities, which includes mortgage banking servicing fees, change in value of mortgage servicing rights, and gain on sale of loans, accounted for $3,425,000 of noninterest income in the 2011 compared to $3,921,000 in 2010. Commissions on sale of nondeposit investment products increased $896,000 (74.1%) in 2011 due to increased focus and resources deployed in that area. The change in indemnification asset of $2,059,000 recorded in 2011 is primarily due to an increase in estimated loan losses from the loan portfolio and foreclosed assets acquired in the Granite acquisition on May 28, 2010, and the fact that such losses are generally covered at the rate of 80% by the FDIC. The actual increase in estimated losses is reflected in decreased interest income, increased provision for loan losses and/or increased provision for foreclosed asset losses. The September 23, 2011 acquisition of Citizens added noninterest income totaling $8,029,000 through December 31, 2011 including a bargain purchase gain of $7,575,000. Also during 2011, the Company recorded a $789,000 gain on life insurance death benefit due to the passing of an insured former employee.

Noninterest income increased $2,366,000 (7.8%) to $32,695,000 in 2010. Service charges on deposit accounts were down $784,000 (4.9%) due to new overdraft regulations that became effective on July 1, 2010 and caused a decrease in non-sufficient funds fees. ATM fees and interchange income was up $1,153,000 (23.4%) due to increased customer point-of -sale transactions that are the result of incentives for such usage. Overall, mortgage banking activities, which includes mortgage banking servicing fees, change in value of mortgage servicing rights, and gain on sale of loans, accounted for $3,921,000 of noninterest income in the 2010 compared to $4,054,000 in 2009. Commissions on sale of nondeposit investment products decreased $423,000 (25.9%) in 2010 due to lower demand for investment products. The change in indemnification asset of $1,274,000 recorded in 2010 is primarily due to an increase in estimated loan losses from the loan portfolio and foreclosed assets acquired in the Granite acquisition on May 28, 2010, and the fact that such losses are generally covered at the rate of 80% by the FDIC. The actual increase in estimated losses is reflected in decreased interest income, increased provision for loan losses and/or increased provision for foreclosed asset losses. The May 28, 2010 acquisition of Granite added noninterest income totaling $1,586,000 through December 31, 2010 including change in indemnification asset of $1,274,000.

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Noninterest Expense

The following table summarizes the Company s other noninterest expense for the periods indicated (dollars in thousands):

	Year ended December 31, 2011	2010	2009
Components of Noninterest Expense			
Salaries and related benefits:			
Base salaries, net of deferred loan origination costs	$ 29,753	$ 28,255	$ 27,110
Incentive compensation	3,735	1,844	2,792
Benefits and other compensation costs	10,715	10,006	9,908
Total salaries and related benefits	44,203	40,105	39,810
Other noninterest expense:			
Occupancy	6,198	5,717	5,096
Equipment	3,770	3,975	3,709
Data processing and software	3,980	3,163	2,807
Assessments	2,491	3,253	3,750
ATM network charges	1,939	1,851	2,433
Advertising	2,649	2,340	2,175
Professional fees	2,004	2,478	1,783
Telecommunications	1,875	1,817	1,689
Postage	935	1,037	991
Courier service	953	826	796
Foreclosed asset expense	755	625	491
Intangible amortization	177	307	328
Operational losses	600	394	314
Provision for foreclosed asset losses	1,984	1,522	220
Change in reserve for unfunded commitments	100	(1,000)	1,075
Other	8,102	8,795	7,983
Total other noninterest expenses	38,512	37,100	35,640
Total noninterest expense	$ 82,715	$ 77,205	$ 75,450
Average full time equivalent staff	687	667	641
Noninterest expense to revenue (FTE)	60.88		

Total assets	**3,955,503**	**3,930,727**

	As of Dec. 31, 2012	As of Dec. 31, 2011
LIABILITIES AND EQUITY		
Current liabilities:		
Short-term loans and current portion of long-term debt	1,866	8,343
Trade payables	325,235	380,532
Accrued income taxes	60,057	45,900
Accrued expenses	291,348	299,422
Other current liabilities	165,929	159,651
Total current liabilities	**844,435**	**893,848**
Long-term debt, excluding current installments	2,117	3,368
Accrued pension and severance cost	272,131	249,604
Other noncurrent liabilities	82,518	70,240
Total liabilities	**1,201,201**	**1,217,060**
Commitments and contingent liabilities		
Equity:		
Canon Inc. stockholders equity:		
Common stock	174,762	174,762
[Authorized shares] (share)	[3,000,000,000]	[3,000,000,000]
[Issued shares] (share)	[1,333,763,464]	[1,333,763,464]
Additional paid-in capital	401,547	401,572
Legal reserve	61,663	59,004
Retained earnings	3,138,976	3,059,298
Accumulated other comprehensive income (loss)	(367,249)	(481,773)
Treasury stock, at cost	(811,673)	(661,731)
[Treasury shares] (share)	[180,972,173]	[132,231,296]
Total Canon Inc. stockholders equity	**2,598,026**	**2,551,132**
Noncontrolling interests	**156,276**	**162,535**
Total equity	**2,754,302**	**2,713,667**
Total liabilities and equity	**3,955,503**	**3,930,727**

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Consolidated Statements of Income

(Millions of yen)

	Year ended Dec. 31, 2012	Year ended Dec. 31, 2011
Net sales	**3,479,788**	**3,557,433**
Cost of sales	1,829,822	1,820,670
Gross profit	**1,649,966**	**1,736,763**
Operating expenses:		
Selling, general and administrative expenses	1,029,646	1,050,892
Research and development expenses	296,464	307,800
	1,326,110	**1,358,692**
Operating profit	**323,856**	**378,071**
Other income (deductions):		
Interest and dividend income	6,792	8,432
Interest expense	(1,022)	(988)
Other, net	12,931	(10,991)
	18,701	**(3,547)**
Income before income taxes	**342,557**	**374,524**
Income taxes	110,112	120,415
Consolidated net income	**232,445**	**254,109**
Less: Net income attributable to noncontrolling interests	7,881	5,479
Net income attributable to Canon Inc.	**224,564**	**248,630**

Notes to Consolidated Balance Sheets

<Notes to Consolidated Balance Sheets as of December 31, 2012>

1. Allowance for doubtful receivables: 12,970 million yen
2. Accumulated depreciation: 2,159,453 million yen
3. Accumulated other comprehensive income (loss) includes foreign currency translation adjustments, net unrealized gains and losses on securities, net gains and losses on derivative financial instruments and pension liability adjustments.

4. Collateral assets:	1,803 million yen
5. Guarantee obligations for bank loans taken out by employees:	13,333 million yen

<Note to Per Share Information as of December 31, 2012>

Canon Inc. stockholders equity per share	2,253.68 yen

<u>Note to Statements of Income</u>

<Note to Per Share Information for the year ended December 31, 2012>

Net income attributable to Canon Inc. stockholders per share

Basic	191.34 yen
Diluted	191.34 yen

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ment of
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(Millions of y

	Common stock	Additional paid-in capital	Legal reserve	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total Canon Inc. stockholders equity	Noncontrolling interests	Tota equit
ance at mber 31,	174,762	401,572	59,004	3,059,298	(481,773)	(661,731)	2,551,132	162,535	2,713,
ity actions ontrolling ests and		(16)		152	(1,866)		(1,730)	(13,591)	(15,
idends to Canon holders				(142,362)			(142,362)		(142,
idends to ontrolling ests								(3,492)	(3,
nsfers to reserve			2,659	(2,659)			-		
nprehensive me:									
income				224,564			224,564	7,881	232,
er nprehensive me), net of									
eign rency nslation ustments					132,704		132,704	1,031	133,

ealized ns and ses on urities					3,148		3,148	117	3,
gains losses vative ruments					(4,882)		(4,882)	2	(4,
sion bility ustments					(14,580)		(14,580)	1,793	(12,
al prehensive ne							340,954	10,824	351,
urchase asury , net		(9)		(17)		(149,942)	(149,968)		(149,
ance at mber 31,	174,762	401,547	61,663	3,138,976	(367,249)	(811,673)	2,598,026	156,276	2,754,

<Note to Consolidated Statement of Equity>

Pension liability adjustments include actuarial loss and prior service credit.

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<Notes to Basic Significant Matters Regarding Preparation of Consolidated Financial Statements>

Significant Accounting Policies

1. Group Position

The number of consolidated subsidiaries was 275, and the number of affiliated companies accounted for by the equity method was 9.

2. Basis of Presentation

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (US GAAP) pursuant to the provision of paragraph 1, Article 120-2 of the Company Accounting Regulations. However, certain disclosures required under US GAAP are omitted pursuant to the provision of the latter part of that paragraph.

3. Cash Equivalents

All highly liquid investments acquired with an original maturity of three months or less are considered to be cash equivalents.

4. Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Exchange differences are charged or credited to income. Assets and liabilities of subsidiaries located outside Japan are translated into Japanese yen at the rates of exchange in effect at the balance sheet date and income and expense items are translated at the average exchange rates prevailing during the year. The resulting translation adjustments are reported in other comprehensive income (loss).

5. Inventories

Inventories are stated at the lower of cost or market value. Cost is determined by the average method for domestic inventories and principally the first-in, first-out method for overseas inventories.

6. Investments

Canon accounts for its debt and marketable equity securities as follows. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, on available for-sale securities are excluded from earnings and are reported in other comprehensive income (loss) until realized. Realized gain and losses are determined on the average cost method.

7. Property, Plant and Equipment

Property, plant and equipment are depreciated principally by the declining-balance method.

8. Goodwill and Other Intangible Assets

Goodwill and other intangible assets with indefinite useful lives are not amortized, but are instead tested for impairment at least annually in the fourth quarter of each year, or more frequently if indicators of potential impairment exist. Intangible assets with finite useful lives are amortized over the respective estimated useful lives. Software is amortized on a straight-line basis over the period of three to five years. Customer relationship is amortized principally by the declining-balance method over the period of five years.

9. Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment, and acquired intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying amount of the asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset.

10. Basis of Recording Allowances

(Allowance for doubtful accounts)

An allowance for doubtful accounts is provided based on credit loss history and an evaluation of any specific doubtful accounts.

(Accrued pension and severance cost)

Pension and severance cost is accrued based on the projected benefit obligations and the fair value of plan assets at the balance sheet date. Unrecognized actuarial loss is recognized by amortizing a portion in excess of a corridor (i.e., 10% of the greater of the projected benefit obligations or the fair value of plan assets) using the straight-line method over the average remaining service period of employees. Unrecognized prior service cost or credit is amortized using the straight-line method over the average remaining service period of employees.

11. Sales Incentives

Canon records estimated reductions to sales at the time of sale for sales incentive programs including product discounts, customer promotions and volume-based rebates. Estimated reductions to sales are based upon historical trends and other known factors at the time of sale. During the year ended December 31, 2012, Canon revised its estimates for sales incentive programs accrual. This change in estimate caused an increase in net income attributable to Canon Inc. by ¥10,785 million.

12. Taxes collected from customers

Taxes collected from customers and remitted to governmental authorities are excluded from revenues, cost and expenses in consolidated statements of income.

13. Stock-Based Compensation

Canon measures stock-based compensation cost at the grant date, based on the fair value of the award, and recognizes the cost on a straight-line basis over the requisite service period.

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14. Net Income Attributable to Canon Inc. Stockholders Per Share

Basic net income attributable to Canon Inc. stockholders per share is computed by dividing net income by the weighted-average number of common shares outstanding during each year. Diluted net income attributable to Canon Inc. stockholders per share includes the effect from potential issuance of common stock based on the assumption that all stock options were exercised.

<Notes to Financial Instruments>

1. Status of Financial Instruments

Canon invests in highly safe and short-term financial instruments.

Canon has certain financial instruments such as trade receivables and securities. Canon reduces the customer credit risk related to trade receivables in accordance with its credit management policy. At December 31, 2012, a major customer accounted for approximately 18% of consolidated trade receivables. Securities consist primarily of equity securities of the companies with which Canon has a business relationship.

Derivative financial instruments are comprised principally of foreign exchange contracts to reduce the risk. Canon does not hold or issue derivative financial instruments for trading and speculative purposes.

2. Fair Value of Financial Instruments

The estimated fair values of Canon s financial instruments as of December 31, 2012 are set forth below. The following summary excludes cash and cash equivalents, trade receivables, finance receivables, noncurrent receivables, short-term loans, trade payables and accrued expenses for which fair values approximate their carrying amounts. The following summary excludes non-marketable equity securities accounted for under the cost method (balance sheet amount 14,808 million yen) as it was not practicable to estimate the fair value of such investments.

			(Millions of yen)
	Carrying amount	Estimated fair value	Difference
Available-for-sale securities	23,340	23,340	-
Long-term debt, including current portion	(3,664)	(3,654)	10
Foreign exchange contracts:			
Assets	831	831	-
Liabilities	(25,493)	(25,493)	-

The following methods and assumptions are used to estimate the fair value in the above table.

Available-for-sale securities

Available-for-sale securities are recorded at fair value.

Long-term debt

The fair values of Canon s long-term debt instruments are based on the present value of future cash flows associated with each instrument discounted using current market borrowing rates for similar debt instruments of comparable maturity.

Foreign exchange contracts

The fair values of foreign exchange contracts are measured based on the market price obtained from financial institutions.

<Note to Real Estate for Rent and Others>

There was no significant item.

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FINANCIAL STATEMENTS

Balance Sheets		(Millions of yen)
	As of Dec. 31, 2012	As of Dec. 31, 2011
ASSETS		
Current assets	**995,363**	**1,157,527**
Cash and deposits	28,719	124,069
Notes receivable	422	140,994
Accounts receivable	552,354	407,299
Short-term investments	51,420	113,680
Finished goods	99,737	79,644
Work in process	78,134	67,150
Raw materials and supplies	6,094	7,016
Deferred tax assets	18,560	19,291
Short-term loans receivable	75,936	117,384
Other current assets	84,385	81,000
Allowance for doubtful receivables	(398)	-
Fixed assets	**1,341,639**	**1,354,081**
Property, plant and equipment, net	**723,256**	**750,924**
Buildings	427,801	445,312
Machinery	85,902	87,975
Vehicles	75	83
Tools and equipment	20,256	21,757
Land	146,898	148,202
Construction in progress	42,324	47,595
Intangible fixed assets	**31,950**	**35,447**
Software	30,424	33,492
Other intangibles	1,526	1,955
Investments and other assets	**586,433**	**567,710**
Investment securities	29,729	25,581
Investments in affiliated companies	495,167	474,009
Long-term loans receivable	1,732	661
Long-term pre-paid expenses	8,317	10,098
Deferred tax assets- noncurrent	48,333	53,805
Guarantees	902	1,009
Other noncurrent assets	2,328	2,601
Allowance for doubtful receivables-noncurrent	(75)	(54)
Total assets	**2,337,002**	**2,511,608**

	As of Dec. 31, 2012	As of Dec. 31, 2011
LIABILITIES AND NET ASSETS		
Current liabilities	**700,617**	**738,180**

Notes payable	1,032	1,503
Accounts payable	292,595	288,526
Short-term loans payable	239,741	282,358
Other payables	40,900	57,873
Accrued expenses	46,028	58,806
Accrued income taxes	40,868	23,614
Deposits	8,066	10,301
Accrued warranty expenses	1,980	2,988
Accrued bonuses for employees	4,382	4,352
Accrued directors bonuses	191	229
Other current liabilities	24,834	7,630
Noncurrent liabilities	**41,697**	**44,332**
Accrued pension and severance cost	33,507	33,014
Accrued directors retirement benefits	1,575	1,789
Reserve for environmental provision	5,084	7,986
Accrued long service rewards for employees	1,522	1,533
Other noncurrent liabilities	9	10
Total liabilities	**742,314**	**782,512**
Stockholders equity	**1,593,998**	**1,728,672**
Common stock	**174,762**	**174,762**
Capital surplus	**306,288**	**306,288**
Additional paid-in capital	306,288	306,288
Retained earnings	**1,924,621**	**1,909,353**
Legal reserve	22,114	22,114
Other retained earnings	1,902,507	1,887,239
Reserve for special depreciation	434	371
Reserve for deferral of capital gain on property	3,089	2,983
Special reserves	1,249,928	1,249,928
Retained earnings brought forward	649,056	633,957
Treasury stock	**(811,673)**	**(661,731)**
Valuation and translation adjustments	**(1,669)**	**(1,719)**
Net unrealized gains (losses) on securities	**699**	**(2,107)**
Net deferred gains (losses) on hedges	**(2,368)**	**388**
Subscription rights to shares	**2,359**	**2,143**
Total net assets	**1,594,688**	**1,729,096**
Total liabilities and net assets	**2,337,002**	**2,511,608**

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Statements of Income

(Millions of yen)

	Year ended Dec. 31, 2012	Year ended Dec. 31, 2011
Net sales	**2,113,420**	**2,160,732**
Cost of sales	1,488,101	1,463,994
Gross profit	**625,319**	**696,738**
Selling, general and administrative expenses	426,624	449,824
Operating profit	**198,695**	**246,914**
Other income	**78,663**	**85,111**
Interest income	1,470	2,032
Dividend income	10,683	15,234
Rental income	38,017	41,476
Royalty income	16,969	17,120
Foreign exchange income	2,655	-
Miscellaneous income	8,869	9,249
Other expenses	**41,630**	**49,973**
Interest expense	2,214	2,238
Depreciation of rental assets	34,631	37,938
Foreign exchange loss	-	1,944
Miscellaneous loss	4,785	7,853
Ordinary profit	**235,728**	**282,052**
Non-ordinary income	**506**	**709**
Gain on sales of fixed assets	231	515
Gain on sales of investment securities	123	194
Gain on reversal of subscription rights to shares	152	-
Non-ordinary loss	**5,128**	**40,612**
Loss on sales and disposal of fixed assets	4,159	4,432
Loss on disaster	-	15,508
Loss on sales of investment securities	-	5,473
Write-off of investment securities	969	1
Loss on sales of investments in affiliated companies	-	34
Write-off of investments in affiliated companies	-	15,164
Income before income taxes	**231,106**	**242,149**
Income taxes - Current	67,327	49,004
- Deferred	6,132	19,944
Net income	**157,647**	**173,201**

Notes to Balance Sheets

<Notes to Balance Sheets as of December 31, 2012>

1. Accumulated depreciation of property, plant and equipment 1,282,327 million yen

2. Guarantees	
Mortgage bank loans for employees	9,455 million yen
3. Receivable and Payable for affiliated companies	
Receivables	683,501 million yen
Payables	506,873 million yen

<Note to Per Share Information as of December 31, 2012>

Net assets per share	1,381.28 yen

Notes to Statements of Income

<Note to Statement of Income for the year ended December 31, 2012>

Transactions with affiliated companies	
Sales	2,060,187 million yen
Purchase	1,539,650 million yen
Other transactions	68,633 million yen

<Note to Per Share Information for the year ended December 31, 2012>

Net income per share	134.32 yen

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Statement of Changes in Net Assets

(Millio

	Stockholders equity									Valuation and translation adjustments		
		Capital surplus	Retained earnings									
				Other retained earnings								
	Common stock -	Additional paid-in capital	Legal reserve	Reserve for special depreciation	Reserve for deferral of capital gain on property	Special reserves	Retained earnings brought forward	Treasury stock	Total stockholders equity	Net unrealized gains (losses) on securities	Net deferred gains (losses) on hedges	Subscription rights to shares
f	174,762	306,288	22,114	371	2,983	1,249,928	633,957	(661,731)	1,728,672	(2,107)	388	2,143
n				240			(240)		-			
n				(177)			177		-			
					201		(201)		-			
					(95)		95		-			
							(142,362)		(142,362)			
							157,647		157,647			
								(150,020)	(150,020)			
							(17)	78	61			

s

								-	2,806	(2,756)	216
-	-	-	63	106	-	15,099	(149,942)	(134,674)	2,806	(2,756)	216
174,762	306,288	22,114	434	3,089	1,249,928	649,056	(811,673)	1,593,998	699	(2,368)	2,359

<Notes to Statements of Changes in Net Assets>

1. Number of issued shares as of December 31, 2012 1,333,763,464 shares
2. Classes and shares of treasury stock

(Shares)

Classes of stock	Balance at the beginning of current period	Increase	Decrease	Balance at the end of current period
Common stock	132,231,296	48,757,036	16,159	180,972,173

(Reason for change)

The increase of 48,757,036 shares reflects the acquisition of 48,750,800 shares as approved by the resolution of the board of directors meeting, and the purchase of shares less-than-one-unit, 6,236 shares in total, requested by shareholders.

The decrease of 16,159 shares reflects the transfer of 10,800 shares due to the exercise of stock options which have vested, and the sale of shares less-than-one-unit, 5,359 shares in total, requested by shareholders.

3. Payment for dividends

(1) Amount of dividends paid

Decision	Classes of stock	Cash dividend (Millions of yen)	Dividend per share (yen)	Record date	Effective date
March 29, 2012 Ordinary general meeting of	common stock	72,092	60.00	December 31, 2011	March 30, 2012

shareholders					
July 25, 2012 Board of directors meeting	common stock	70,270	60.00	June 30, 2012	August 27, 2012

(2) Dividends whose record date is included in the current fiscal year and effective date is after the current fiscal year-end.

Scheduled	Classes of stock	Cash dividend (Millions of yen)	A source of dividend	Dividend per share (yen)	Record date	Effective date
March 28, 2013 Ordinary general meeting of shareholders	common stock	80,695	Retained earnings	70.00	December 31, 2012	March 29, 2013

Notes to Non-Consolidated Financial Statements

<Notes to Significant Accounting Policies>

1. Valuation of Securities

(1) Securities of subsidiaries and affiliates----stated at cost based on the moving average method.
(2) Other securities:

Securities with quotation----stated at fair value (unrealized holdings gains and losses are reported in net assets, when sold, the cost is based on the moving average method).

Securities without quotation----stated at cost based on the moving average method.

2. Valuation of Inventories

(1) Finished goods; work in process----valued at cost based on the periodic average method (amount shown in the balance sheet is devaluated due to decline in profitability).
(2) Raw materials and supplies----valued at cost based on the moving average method (amount shown in the balance sheet is devaluated due to decline in profitability).

3. Depreciation Method of Fixed Assets

(1) Property, plant and equipment (excluding lease assets) --- calculated by declining-balance method. For buildings (excluding fixtures) acquired on or after April 1,1998, depreciation is calculated by straight-line method.
(2) Intangible fixed assets----calculated by straight-line method. With regard to software for sale, calculated based on the estimated marketable period in consideration of marketing plan etc. of the relevant products (3 years), and with regard to internal-use software, calculated based on the estimated useful period in the Company (5 years).
(3) Lease assets----calculated by straight-line method. The engaged lease period is determined as the useful life of each lease asset.

4. Deferred Charges----The items which can be deferred under the Corporation Law charged to operations as incurred.

5. Basis of Recording Allowances

(1) Allowance for doubtful accounts----provided as general provision for uncollectible receivables

----General accounts

Allowances are provided using a rate determined by past debt experience.

----Allowance for accounts considered to be uncollectible and accounts in bankruptcy filing are provided for individual estimated uncollectible amount, primarily determined based on the respective customer s financial conditions.

(2) Accrued warranty expenses----provided as general provision for product after-sales service expenses and no charge repair cost on an estimated amount based on the historical performance.
(3) Accrued bonuses for employees----provided as general provision for bonus to employees for this term based on an amount expected to pay.
(4) Accrued directors bonuses----provided as general provision for bonus to directors for this term based on an amount expected to pay.
(5) Accrued pension and severance cost----provided as general provision for employee retirement and severance benefits based on projected benefits obligation and expected plan asset. Prior service cost and actuarial variance are amortized by straight-line method with average remaining service periods.

(6) Accrued directors retirement benefits----Provision for directors retirement benefits based on the necessary amount at the fiscal year-end in accordance with management policy.
(7) Reserve for environmental provision----provided as general provision for the future environmental-related cost, such as construction costs to prevent the proliferation of soil pollution, and also clean up costs of hazardous substances based on the related regulations.
(8) Accrued long service rewards for employees----provided as general provision for reward for employees in accordance with management policy for long service employees for this term based on an amount expected to pay.

6. Hedge accounting

(1) Hedge accounting----Deferral hedge accounting has been applied.
(2) Hedging instrument and hedged items
Hedging instrument----derivative transaction (foreign exchange contract)
Hedged items----accounts receivables denominated in foreign currency for forecasted transaction
(3) Hedge policy----Derivative financial instruments are comprised principally of foreign exchange contracts to manage currency risk. The Company does not hold derivative financial instrument for trading purpose.
(4) Assessment of hedge effectiveness----As the substantial terms of hedging instruments and of hedged items are the same, the fluctuations of foreign currency exchange rates are offset by each other at the hedge s inception and on an ongoing basis. Hedge effectiveness is assessed by verifying those relationships.

7. Notes to Others

(1) Consumption Taxes----excluded from the statements of income and are accumulated in other receivables or other payables.
(2) Consolidated Taxation System----applied

<Notes to Deferred Income Tax>

Major items of deferred tax assets and liabilities

(Deferred tax assets)	
Accrued pension and severance cost	20,996 million yen
Loss on devaluation of investments in subsidiaries	4,459 million yen
Loss on disposal and write-off of inventories	2,701 million yen
Outstanding enterprise tax	3,622 million yen
Depreciation of fixed assets in excess of limit	4,113 million yen

Loss on impairment of fixed assets	1,989 million yen
Excess in amortization of software	12,317 million yen
Amortization of deferred charges in excess of limit	7,772 million yen
Other	19,580 million yen
Subtotal deferred tax assets	77,549 million yen
Valuation reserve	(6,766) million yen
Total deferred tax assets	70,783 million yen
(Deferred tax liabilities)	
Reserve for special depreciation	(263) million yen
Reserve for deferral of capital gain on property	(1,867) million yen
Other	(1,760) million yen
Total deferred tax liabilities	(3,890) million yen
Net deferred tax assets	66,893 million yen

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<Notes to Transaction with Related Parties>

(Millions of yen)

Status	Company name	Ratio of voting rights held by the Company	Relationship with the Company	Transaction details	Transaction amount	Item	Balance as of December 31, 2012
Subsidiary	Canon Marketing Japan Inc.	(Possession) Direct: 57.0% Indirect: 0.0%	Sales of the Company s products Interlocking directorate	Sales of the Company s products	249,438	Accounts receivable	75,339
				Borrowings of funds	-	Short-term loans payable	40,000
Subsidiary	Oita Canon Inc.	(Possession) Direct: 100%	Production of the Company s products Interlocking directorate	Purchase of products, components and others	261,190	Accounts payable	59,586
Subsidiary	Canon Finetech Inc.	(Possession) Direct: 100%	Production of the Company s products Interlocking directorate	Borrowings of funds	3,000	Short-term loans payable	30,000
Subsidiary	Canon U.S.A., Inc.	(Possession) Direct: 100%	Sales of the Company s products Interlocking directorate	Sales of the Company s products	539,885	Accounts receivable	143,860
				Borrowings of funds	(43,550)	Short-term loans payable	30,303
Subsidiary	Canon Europa N.V.	(Possession) Indirect: 100%	Sales of the Company s products Interlocking directorate	Sales of the Company s products	622,940	Accounts receivable	164,524
				Borrowings of funds	(4,307)	Short-term loans payable	37,838
Subsidiary	Canon Singapore Pte. Ltd.	(Possession) Direct: 100%	Sales of the Company s products Interlocking directorate	Sales of the Company s products	222,399	Accounts receivable	57,569

Subsidiary	Canon (China) Co., Ltd.	(Possession) Direct: 100%	Sales of the Company s products Interlocking directorate	Sales of the Company s products	178,489	Accounts receivable	34,182
Subsidiary	CANON Inc., Taiwan	(Possession) Direct: 79.3% Indirect: 20.7%	Production of the Company s products Interlocking directorate	Purchase of products, components and others	97,695	Accounts payable	27,749
Subsidiary	Canon Finance Netherlands B.V.	(Possession) Direct: 100%	Europe region holding Company Interlocking directorate	Contribution in kind	50,040	-	-

Conditions of transactions and policy regarding determination of conditions of transaction.

(Note 1) The transactions above are determined on a fair price basis.

(Note 2) Consumption taxes are excluded from the transaction amount, however, included in the balance at December 31, 2012.

(Note 3) The loans payable from Canon Marketing Japan Inc., Canon Finetech Inc., Canon U.S.A., Inc. and Canon Europa N.V. are intended to make best use of the funding in the Canon Group. Transaction amount shows net loan and repayment. The interests are determined reasonably based on market interest rate.

(Note 4) Ratio of voting rights held by the Company for Indirect of Canon Marketing Japan Inc. shows 0.0% because the value is a fraction amount.

(Note 5) The shares of Canon Europa N.V. is the Property contributed in kind received as the result of the capital increase by Canon Finance Netherlands B.V.

<Footnotes for Additional Information>

For accounting changes and corrections of errors in past made after the beginning of the fiscal year, the Company adopted the Accounting Standard for Accounting Changes and Error Corrections (ASBJ Statement No. 24, December 4, 2009) and the Guidance on Accounting Standard for Accounting Changes and Error Corrections (ASBJ Guidance No. 24, December 4, 2009).

ACCOUNTING AUDIT REPORT OF ACCOUNTING AUDITOR ON CONSOLIDATED FINANCIAL STATEMENTS

(TRANSLATION)

Report of Independent Auditors

February 12, 2013

The Board of Directors

Canon Inc.

Ernst & Young ShinNihon LLC

Noriharu Fujita	Certified Public Accountant Designated and Engagement Partner
Norimitsu Yanai	Certified Public Accountant Designated and Engagement Partner
Shigeru Sekiguchi	Certified Public Accountant Designated and Engagement Partner
Nobuaki Kenmochi	Certified Public Accountant Designated and Engagement Partner

Pursuant to Paragraph 4, Article 444 of the Corporation Law, we have audited the accompanying consolidated financial statements, which comprise the consolidated balance sheet, the consolidated statement of income, the consolidated statement of equity and the notes to consolidated financial statements of Canon Inc. (the Company) applicable to the fiscal year from January 1, 2012 through December 31, 2012.

Management s Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with the provision of the second sentence, Paragraph 1, Article 120-2 of the Company Accounting Regulations, which permits the omission of certain disclosure items required under the accounting principles generally accepted in the United States, and for designing and operating such internal control as management determines is necessary to enable the preparation and fair presentation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors Responsibility

Our responsibility is to express an opinion from an independent perspective on the consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures are selected and applied depending on the auditors judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors do not consider internal control for the purpose of expressing an opinion on its effectiveness, but consider internal control relevant to the entity s preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used, the method of their application, and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above, which omits some disclosure items required under the accounting principles generally accepted in the United States in accordance with the provision of the second sentence, Paragraph 1, Article 120-2 of the Company Accounting Regulations, present fairly, in all material respects, the financial position and results of operations of the Canon Group, which consisted of the Company and consolidated subsidiaries, applicable to the fiscal year ended December 31, 2012.

Conflicts of Interest

We have no interest in the Company which should be disclosed in compliance with the Certified Public Accountants Act.

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ACCOUNTING AUDIT REPORT OF ACCOUNTING AUDITOR

(TRANSLATION)

Report of Independent Auditors

February 12, 2013

The Board of Directors

Canon Inc.

Ernst & Young ShinNihon LLC

Noriharu Fujita	Certified Public Accountant Designated and Engagement Partner
Norimitsu Yanai	Certified Public Accountant Designated and Engagement Partner
Shigeru Sekiguchi	Certified Public Accountant Designated and Engagement Partner
Nobuaki Kenmochi	Certified Public Accountant Designated and Engagement Partner

Pursuant to Item 1, Paragraph 2, Article 436 of the Corporation Law, we have audited the accompanying financial statements, which comprise the balance sheet, the statement of income, the statement of changes in net assets, the notes to non-consolidated financial statements, and the related supplementary schedules of Canon Inc. (the Company) applicable to the 112th fiscal year from January 1, 2012 through December 31, 2012.

Management s Responsibility for the Financial Statements and the Related Supplementary Schedules

Management is responsible for the preparation and fair presentation of the financial statements and the related supplementary schedules in accordance with accounting principles generally accepted in Japan, and for designing and operating such internal control as management determines is necessary to enable the preparation and fair presentation of the financial statements and the related supplementary schedules that are free from material misstatement, whether due to fraud or error.

Auditors Responsibility

Our responsibility is to express an opinion from an independent perspective on the financial statements and the related supplementary schedules based on our audit. We conducted our audit in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and the related supplementary schedules are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements and the related supplementary schedules. The procedures are selected and applied depending on the auditors judgment, including the assessment of the risks of material misstatement of the financial statements and the related supplementary schedules, whether due to fraud or error. In making those risk assessments, the auditors do not consider internal control for the purpose of expressing an opinion on its effectiveness, but consider internal control relevant to the entity s preparation and fair presentation of the financial statements and the related supplementary schedules in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used, the method of their application, and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements and the related supplementary schedules.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements and the related supplementary schedules referred to above present fairly, in all material respects, the financial position and results of operations of Canon Inc. applicable to the 112th fiscal year ended December 31, 2012 in conformity with accounting principles generally accepted in Japan.

Conflicts of Interest

We have no interest in the Company which should be disclosed in compliance with the Certified Public Accountants Act.

AUDIT REPORT OF AUDIT & SUPERVISORY BOARD

Audit Report

Regarding the performance of duties by the Directors for the 112th business term from January 1, 2012, to December 31, 2012, we have prepared this Audit Report upon deliberation based on the audit reports prepared by each Audit & Supervisory Board Member and hereby report as follows:

1. Auditing Methods Employed by the Audit & Supervisory Board Members and Audit & Supervisory Board and Details of Such Audit

We established auditing policies, allocation of duties and other relevant matters, and received reports from each Audit & Supervisory Board Member regarding their execution of audits and results thereof, as well as reports from the Directors, other relevant personnel, and the Accounting Auditor regarding performance of their duties, and sought explanations as necessary.

Each Audit & Supervisory Board Member complied with the auditing standards of Audit & Supervisory Board Members established by the Audit & Supervisory Board, followed the auditing policies, allocation of duties, and other relevant matters, communicated with such as the Directors, the internal auditing and other employees, and made efforts to establish the environment for collecting information and auditing, and participated in the meetings of the Board of Directors and other important meetings, received reports from such as the Directors and employees regarding performance of their duties, sought explanations as necessary, examined important authorized documents and associated information, and studied the operations and status of assets at the headquarters and principal offices. In addition, we periodically received reports regarding the status of establishment and operation from Directors, employees and others, requested explanations as necessary, and expressed opinions regarding the system for ensuring that the performance of duties by the Directors conforms to the related laws and regulations and Articles of Incorporation, as well as the resolution of the Board of Directors regarding the organization of the system stipulated in Item 1 and Item 3, Article 100, of the Enforcement Regulations of the Corporation Law and the status of the system based on such resolution (Internal Control System), which are necessary for ensuring propriety of company s operations, both of which are described in the business report. With respect to subsidiaries, we communicated and exchanged information with Directors and Audit & Supervisory Board Members of subsidiaries, and received business reports from subsidiaries as necessary. Based on the above methods, we examined the business report and the accompanying detailed statements for this business term.

Furthermore, we monitored and verified whether the Accounting Auditor maintained their independence and implemented appropriate audits, and we received reports from the Accounting Auditor regarding the performance of their duties and sought explanations as necessary. In addition, we received notice from the Accounting Auditor that System for ensuring that duties are performed properly (matters set forth in each item of Article 131 of the Company Accounting Regulations) is organized in accordance with the Quality Management Standards Regarding Audits (Business Accounting Council, October 28, 2005) and other relevant standards, and sought explanations as necessary. Based on the above methods, we examined the financial statements (balance sheet, statement of income, statement of changes in net assets, and notes to non-consolidated financial statements) and the accompanying detailed statements as well as the consolidated financial statements (consolidated balance sheet, consolidated statement of income, consolidated statement of equity, and notes to consolidated financial statements) for this business term.

2. Audit Results

(1) Results of Audit of Business Report and Other Relevant Documents

1. We confirm that the business report and the accompanying detailed statements fairly represent the Company s conditions in accordance with the related laws and regulations and Articles of Incorporation.

2. We have found no significant evidence of wrongful act or violation of related laws and regulations, nor the Articles of Incorporation with regard to the performance of duties by the Directors.

3. We confirm that the content of the resolution of the Board of Directors regarding the Internal Control System is proper. In addition, we have found no matters on which to remark in regard to the performance of duties by the Directors regarding the Internal Control System.

(2) Results of Audit of financial statements and the accompanying detailed statements

We confirm that the methods and results of the audit employed by the Accounting Auditor, Ernst Young ShinNihon LLC, are proper.

(3) Results of Audit of consolidated financial statements

We confirm that the methods and results of the audit employed by the Accounting Auditor, Ernst Young ShinNihon LLC, are proper.

February 12, 2013

Audit & Supervisory Board, Canon Inc.

Audit & Supervisory Board Member	Shunji Onda
Audit & Supervisory Board Member	Kengo Uramoto
Audit & Supervisory Board Member	Tadashi Ohe
Audit & Supervisory Board Member	Kazunori Watanabe
Audit & Supervisory Board Member	Kuniyoshi Kitamura

Note: Audit & Supervisory Board Members, Tadashi Ohe, Kazunori Watanabe and Kuniyoshi Kitamura are Outside Audit & Supervisory Board Members, as provided in Item 16, Article 2, and Paragraph 3, Article 335, of the Corporation Law.

REFERENCE
Topics

Canon Photo Studio of Memories Held at Area Hit by 2011 Earthquake

Canon set up the Canon Photo Studio of Memories during a summer festival held in July at the temporary housing in Higashi Matsushima City, Miyagi Prefecture.

The studio was set up in cooperation with Marine Support Northeast Japan Youth Aid Team, a non- profit organization that has been carrying out relief activities in the areas affected immediately after the Great East Japan Earthquake. At the improvised studio, volunteer Canon employees took pictures of visitors, which were printed using a PIXUS (PIXMA) inkjet printer and given to the visitors. Many of the visitors had lost their photo albums due to the tsunami, and they expressed their appreciation with such comments as: I m very happy as I wanted to have a photo of my family.

Support for WWF s Conservation Activities

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In July, Canon Europe announced the renewal of its Conservation Partner agreement with the WWF (World Wide Fund for Nature), which has been in effect since 1998. It also announced that it will start providing support for WWF s conservation activities primarily at the North Pole, over the next three years.

To support the research of glaciers at the North Pole, Canon

		Europe provides digital camcorders and interchangeable-lens digital cameras. It will also continue to carry out support activities including operating an online database and providing photography training to WWF staff.

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Canon Foundation Held Research Grant Award Ceremony

The Canon Foundation s third research grant award ceremony was held in April at Keidanren Kaikan in Chiyoda-ku, Tokyo.

Established in December 2008 to commemorate Canon s 70th anniversary, the Canon Foundation aims to contribute to the ongoing prosperity and well-being of mankind through a wide range of support activities for both organizations and individuals engaged in research, business and education in various academic fields, beginning with science and technology, as well as for cultural pursuits.

There were approximately 400 applications for this round of research grants in the two programs of Creation of Industrial Infrastructure and Pursuit of Ideals. A total of ¥300 million in grants was awarded for 17 research themes.

Eagles Festival 2012

Canon s rugby team, the Canon Eagles, held the Eagles Festival 2012 in May as an event to give thanks to the team s fans.

About 500 people attended the festival, including players of children s rugby teams, their coaches and parents, as well as fans of the team. The festival included autograph-signing sessions by the players, prize draws for Eagles goods, and an event in which the children could try out their rugby skills with the Eagles players. There was also an interleague game between children s rugby schools, called the Eagles Cup, which enabled the children to enjoy playing a game on real grass.

Information for Shareholders

Business term	From January 1 to December 31 of each year
Ordinary general meeting of shareholders	March of each year
Record date for above	December 31 of each year
Record date for interim dividends	June 30 of each year
Manager of the register of shareholders / Account management institution for the special account *(tokubetsu koza)*	2-1, Yaesu 1-chome, Chuo-ku, Tokyo Mizuho Trust & Banking Co., Ltd.
Business handling place	Stock Transfer Agency Department, Head Office Mizuho Trust & Banking Co., Ltd.
Number of shares constituting one unit	100 shares
Newspaper in which public notices are inserted	The Nihon Keizai Shimbun
Stock exchange listings	Tokyo, Osaka, Nagoya, Fukuoka, Sapporo and New York
Securities code	7751

Information on Share Handling Procedures

1. Should you have any inquiries about the following procedures pertaining to shares of Canon Inc., please contact your securities company etc.

Address change	Name change	Inheritance
Dividend transfer designation	Requests for purchase or sale of shares less than one unit	Issuance of certification such as change in shares etc.

2. Should you have any inquiries about the above procedures in cases where your shares are managed in a special account *(tokubetsu koza)* (*), or about procedures for payment of accrued dividends or the issuance of documents such as statements of payment, Mizuho Trust & Banking Co., Ltd. handles these procedures, so please contact as shown below.

Website Mizuho Trust & Banking Co., Ltd.

	(procedures pertaining to shares)
Phone	http://www.mizuho-tb.co.jp/daikou/index.html 0120-288-324 (Toll free, available in Japan only) Operating hours: 9:00 17:00 (Monday Friday except national holidays)
Address	Stock Transfer Agency Department of Mizuho Trust & Banking Co., Ltd. 8-4, Izumi 2-chome, Suginami-ku, Tokyo 168-8507

* A special account is an account for the management of shares that are not managed at a securities company etc. For the sale of shares that are managed in a special account, it is necessary to carry out procedures for the transfer of such shares to an account at a securities company etc. Should you have any inquiries about such procedures, please contact Mizuho Trust & Banking Co., Ltd.

For those shareholders who receive dividends by

way of Receipt of Dividend

The way to receive dividends is shown on the backside of Receipt of Dividend.

We recommend one of the following three methods as a safer and more expeditious way to receive dividends. For more information, please ask your securities company etc.

i) The method of depositing the dividends of all the issues, including shares of Canon Inc., that are managed by a shareholder using securities company accounts into said securities company accounts. (System of allocating dividends to securities company accounts in proportion to the number of shares held in respective accounts)

ii) The method of transferring the dividends of all the issues, including shares of Canon Inc., held by a shareholder into one and the same bank deposit account. (System of receiving dividends in the account registered for receipt of dividends)

iii) The method of transferring dividends into an account at a financial institution such as a bank (including Japan Post Bank). (System of designating an account for each issue held)

* It is not possible to use method i) for shares that are managed in a special account.

* In the case of method ii), it is not possible to choose a Japan Post Bank account as the account into which the dividends are transferred.

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To Shareholders Holding Shares Less Than One Unit

The trading unit of Canon Inc. shares (1 unit) is 100 shares and you can not purchase or sell the Canon Inc. shares less than one unit (1 99 shares; hereinafter Less-than-one-unit Shares) on securities markets. However, you may purchase or sell these shares by the methods below.

(Example: For a shareholder holding 80 shares)

* In the case that you are a shareholder of Less-than-one-unit Shares in an account of securities company etc., please carry out procedures at the securities company etc.

* In the case that you are a shareholder of Less-than-one-unit Shares in a special account (a shareholder who does not have account in securities company etc.), please contact our manager of the register of shareholders (Mizuho Trust & Banking Co., Ltd. 0120-288-324, toll free, available in Japan only).