

TRICO BANCSHARES /  
Form 10-Q  
November 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**for the quarterly period ended: September 30, 2012**

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

**for the transition period from            to            .**

**Commission File Number: 000-10661**

**TriCo Bancshares**

**(Exact Name of Registrant as Specified in Its Charter)**

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**CALIFORNIA**  
(State or Other Jurisdiction of

**94-2792841**  
(I.R.S. Employer

Incorporation or Organization)

Identification Number)

**63 Constitution Drive**

**Chico, California 95973**

(Address of Principal Executive Offices)(Zip Code)

**(530) 898-0300**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  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

Indicate the number of shares outstanding for each of the issuer's classes of common stock, as of the latest practical date:

Common stock, no par value: 15,992,893 shares outstanding as of November 2, 2012

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TriCo Bancshares

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**FORWARD-LOOKING STATEMENTS**

This report on Form 10-Q contains forward-looking statements about TriCo Bancshares (the "Company") that are subject to the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on the current knowledge and belief of the Company's management ("Management") 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, it may mean the Company is 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. The reader is directed to the Company's annual report on Form 10-K for the year ended December 31, 2011, and Part II, Item 1A of this report for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those suggested by any forward-looking statement made in this report. Such Form 10-K and this report should be read to put any forward-looking statements in context and to gain a more complete understanding of the risks and uncertainties involved in the Company's business. Any forward-looking statement may turn out to be wrong and cannot be guaranteed. The Company does not intend to update any forward-looking statement after the date of this report.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****TRICO BANCSHARES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data; unaudited)

	At September 30, 2012	At December 31, 2011
<b>Assets:</b>		
Cash and due from banks	\$ 64,024	\$ 73,652
Cash at Federal Reserve and other banks	558,470	563,623
Cash and cash equivalents	622,494	637,275
Securities available-for-sale	183,432	229,223
Restricted equity securities	9,647	10,610
Loans held for sale	14,937	10,219
Loans	1,575,647	1,551,032
Allowance for loan losses	(44,146)	(45,914)
Total loans, net	1,531,501	1,505,118
Foreclosed assets, net	10,185	16,332
Premises and equipment, net	24,083	19,893
Cash value of life insurance	50,742	50,403
Interest receivable	7,638	7,312
Goodwill	15,519	15,519
Other intangible assets, net	1,144	1,301
Mortgage servicing rights	4,485	4,603
Indemnification asset	2,485	4,405
Other assets	37,189	43,384
Total assets	\$ 2,515,481	\$ 2,555,597
<b>Liabilities and Shareholders' Equity:</b>		
<b>Liabilities:</b>		
<b>Deposits:</b>		
Noninterest-bearing demand	\$ 592,529	\$ 541,276
Interest-bearing	1,609,110	1,649,260
Total deposits	2,201,639	2,190,536
Interest payable	1,139	1,674
Reserve for unfunded commitments	2,555	2,740
Other liabilities	32,449	30,427
Other borrowings	9,264	72,541
Junior subordinated debt	41,238	41,238

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Total liabilities	2,288,284	2,339,156
<b>Commitments and contingencies (Note 18)</b>		
Shareholders' equity:		
Common stock, no par value: 50,000,000 shares authorized; issued and outstanding:		
15,992,893 at September 30, 2012	85,088	
15,978,958 at December 31, 2011		84,079
Retained earnings	138,474	128,551
Accumulated other comprehensive income, net of tax	3,635	3,811
Total shareholders' equity	227,197	216,441
Total liabilities and shareholders' equity	\$ 2,515,481	\$ 2,555,597

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

**Table of Contents****TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share data; unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
<b>Interest and dividend income:</b>				
Loans, including fees	\$ 25,530	\$ 21,987	\$ 76,251	\$ 65,444
<b>Debt securities:</b>				
Taxable	1,443	2,132	4,790	6,853
Tax exempt	108	134	323	410
Dividends	12	6	39	20
Interest bearing cash at Federal Reserve and other banks	372	213	1,170	646
<b>Total interest and dividend income</b>	<b>27,465</b>	<b>24,472</b>	<b>82,573</b>	<b>73,373</b>
<b>Interest expense:</b>				
Deposits	1,106	1,543	3,367	5,172
Other borrowings	395	610	1,602	1,803
Junior subordinated debt	333	312	1,003	934
<b>Total interest expense</b>	<b>1,834</b>	<b>2,465</b>	<b>5,972</b>	<b>7,909</b>
<b>Net interest income</b>	<b>25,631</b>	<b>22,007</b>	<b>76,601</b>	<b>65,464</b>
<b>Provision for loan losses</b>	<b>532</b>	<b>5,069</b>	<b>7,899</b>	<b>17,631</b>
<b>Net interest income after provision for loan losses</b>	<b>25,099</b>	<b>16,938</b>	<b>68,702</b>	<b>47,833</b>
<b>Noninterest income:</b>				
Service charges and fees	5,783	5,584	17,890	17,487
Gain on sale of loans	1,430	598	4,317	1,818
Commissions on sale of non-deposit investment products	803	542	2,464	1,550
Increase in cash value of life insurance	450	450	1,350	1,350
Bargain purchase gain		7,575		7,575
Other	661	(26)	1,948	2,544
<b>Total noninterest income</b>	<b>9,127</b>	<b>14,723</b>	<b>27,969</b>	<b>32,324</b>
<b>Noninterest expense:</b>				
Salaries and related benefits	12,362	11,930	37,614	33,438
Other	13,228	8,943	35,258	27,201
<b>Total noninterest expense</b>	<b>25,590</b>	<b>20,873</b>	<b>72,872</b>	<b>60,639</b>

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Income before income taxes	8,636	10,788	23,799	19,518
Provision for income taxes	3,616	4,318	9,527	7,477
Net income	\$ 5,020	\$ 6,470	\$ 14,272	\$ 12,041
Earnings per share:				
Basic	\$ 0.31	\$ 0.40	\$ 0.89	\$ 0.76
Diluted	\$ 0.31	\$ 0.40	\$ 0.89	\$ 0.75
Dividends per share	\$ 0.09	\$ 0.09	\$ 0.27	\$ 0.27

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



**Table of Contents****TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(In thousands; unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Net income	\$ 5,020	\$ 6,470	\$ 14,272	\$ 12,041
Other comprehensive income, net of tax:				
Unrealized holding gains (losses) on securities arising during the period	98	824	(176)	2,158
Other comprehensive income (loss)	98	824	(176)	2,158
Comprehensive income	\$ 5,118	\$ 7,294	\$ 14,096	\$ 14,199

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

**TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(In thousands, except share and per share data; unaudited)

	Shares of Common Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2010	15,860,138	\$ 81,554	\$ 117,533	\$ 1,310	\$ 200,397
Net income			12,041		12,041
Other comprehensive income				2,158	2,158
Stock option expense		553			553
Stock options exercised	296,250	2,428			2,428
Tax benefit of stock options exercised		296			296
Repurchase of common stock	(177,430)	(915)	(1,830)		(2,745)
Dividends paid (\$0.27 per share)			(4,304)		(4,304)
Balance at September 30, 2011	15,978,958	\$ 83,916	\$ 123,440	\$ 3,468	\$ 210,824
Balance at December 31, 2011	15,978,958	\$ 84,079	\$ 128,551	\$ 3,811	\$ 216,441
Net income			14,272		14,272
Other comprehensive loss				(176)	(176)
Stock option expense		800			800
Stock options exercised	17,000	204			204
Tax benefit of stock options exercised		21			21
Repurchase of common stock	(3,065)	(16)	(32)		(48)

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Dividends paid (\$0.27 per share)				(4,317)		(4,317)
Balance at September 30, 2012	15,992,893	\$ 85,088	\$ 138,474	\$	3,635	\$ 227,197

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands; unaudited)

	For the nine months ended September 30,	
	2012	2011
Operating activities:		
Net income	\$ 14,272	\$ 12,041
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment, and amortization	3,221	2,433
Amortization of intangible assets	157	125
Provision for loan losses	7,899	17,631
Amortization of investment securities premium, net	907	1,025
Originations of loans for resale	(162,082)	(87,677)
Proceeds from sale of loans originated for resale	160,286	82,956
Gain on sale of loans	(4,317)	(1,818)
Change in market value of mortgage servicing rights	1,513	1,022
Provision for losses on foreclosed assets	1,520	1,393
(Gain) loss on sale of foreclosed assets	(364)	(467)
Loss on disposal of fixed assets	404	15
Increase in cash value of life insurance	(1,350)	(1,350)
Gain on life insurance death benefit	(600)	
Proceeds from life insurance	1,611	
Stock option vesting expense	800	553
Stock option excess tax benefits	(21)	(296)
Bargain purchase gain		(7,575)
Change in reserve for unfunded commitments	(185)	
Change in:		
Interest receivable	(326)	(266)
Interest payable	(535)	(336)
Other assets and liabilities, net	9,563	3,258
Net cash from operating activities	32,373	22,667
Investing activities:		
Proceeds from maturities of securities available-for-sale	58,395	57,479
Purchases of securities available-for-sale	(13,815)	(25,456)
Redemption (purchase) of restricted equity securities, net	963	(65)
Loan principal (increases) decreases, net	(40,098)	(9,112)
Proceeds from sale of foreclosed assets	11,281	5,168
Improvements of foreclosed assets	(474)	
Proceeds from sale of premises and equipment	33	1
Purchases of premises and equipment	(7,077)	(2,505)
Cash received from acquisitions		80,706
Net cash from investing activities	9,208	106,216
Financing activities:		
Net increase in deposits	11,103	28,151
Net change in other borrowings	(63,277)	(1,139)
Stock option excess tax benefits	21	296
Repurchase of common stock	(48)	(753)

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Dividends paid	(4,317)	(4,304)
Exercise of stock options	156	436
Net cash (used in) from financing activities	(56,362)	22,687
Net change in cash and cash equivalents	(14,781)	151,570
Cash and cash equivalents at beginning of period	637,275	371,066
Cash and cash equivalents at end of period	\$ 622,494	\$ 522,636
Supplemental disclosure of noncash activities:		
Loans transferred to other real estate owned	\$ 5,816	\$ 5,638
Change in unrealized gain on securities available for sale	\$ (304)	\$ 3,724
Market value of shares tendered by employees in-lieu of cash to pay for exercise options and/or related taxes	\$ 48	\$ 1,992
Supplemental disclosure of cash flow activity:		
Cash paid for interest expense	\$ 6,507	\$ 8,245
Cash paid for income taxes	\$ 7,320	\$ 9,725
Assets acquired in acquisition		\$ 270,304
Liabilities acquired in acquisition		\$ 262,729

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

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**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Summary of Significant Accounting Policies**

**Description of Business**

TriCo Bancshares is a California corporation organized to act as a bank holding company for Tri Counties Bank. The Bank is a state-chartered financial institution that is engaged 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. The Company also formed two subsidiary business trusts, TriCo Capital Trust I and TriCo Capital Trust II, to issue trust preferred securities.

**Basis of Presentation**

The following unaudited condensed financial statements of the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. In the opinion of Management, all adjustments, consisting solely of normal recurring adjustments, considered necessary for a fair presentation of results for the interim periods presented have been included. These interim condensed consolidated financial statements should be read in conjunction with the financial statements and related notes contained in the Company's 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2012.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned financial subsidiary, Tri Counties Bank. All significant intercompany balances and transactions have been eliminated. TriCo Capital Trust I and TriCo Capital Trust II, which were formed solely for the purpose of issuing trust preferred securities, are unconsolidated subsidiaries as the Company is not the primary beneficiary of the trusts and they are not considered variable interest entities. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. Certain amounts in the consolidated financial statements for the year ended December 31, 2011 and for the three and nine months ended September 30, 2011 may have been reclassified to conform to the presentation of the condensed consolidated financial statements in 2012.

**Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to the adequacy of the allowance for loan losses, investments, intangible assets, income taxes and contingencies. 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 allowance for loan losses, goodwill and other intangible assets, income taxes, fair value of assets acquired and liabilities assumed in business combinations, and the valuation of mortgage servicing rights are the only accounting estimates that materially affect the Company's consolidated financial statements.

As described in Note 2, the Bank assumed the banking operations of a failed financial institutions from the FDIC under whole bank purchase agreements. The acquired assets and assumed liabilities were measured at estimated fair value values as required by Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 805, Business Combinations. The Company made significant estimates and exercised significant judgment in accounting for the acquisitions. The Company determined loan fair values based on loan file reviews, loan risk ratings, appraised collateral values, expected cash flows and historical loss factors. Foreclosed assets were primarily valued based on appraised values of the repossessed loan collateral. An identifiable intangible was also recorded representing the fair value of the core deposit customer base based on an evaluation of the cost of such deposits relative to alternative funding sources. The fair value of time deposits and borrowings were determined based on the present value of estimated future cash flows using current rates as of the acquisition date.

**Significant Group Concentration of Credit Risk**

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The Company grants agribusiness, commercial, consumer, and residential loans to customers located throughout the northern San Joaquin Valley, the Sacramento Valley and northern mountain regions of California. The Company has a diversified loan portfolio within the business segments located in this geographical area. The Company currently classifies all its operation into one business segment that it denotes as community banking.

### **Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold.

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The Company classifies its debt and marketable equity securities into one of three categories: trading, available-for-sale or held-to-maturity. Trading securities are bought and held principally for the purpose of selling in the near term. Held-to-maturity securities are those securities which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity are classified as available-for-sale. During the nine months ended September 30, 2012 and the year ended December 31, 2011, the Company did not have any securities classified as either held-to-maturity or trading. Available-for-sale securities are recorded at fair value. Unrealized gains and losses, net of the related tax effect, on available-for-sale securities are reported as a separate component of other accumulated comprehensive income (loss) in shareholders' equity until realized. Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned. Realized gains and losses are derived from the amortized cost of the security sold.

The Company assesses other-than-temporary impairment ( OTTI ) based on whether it intends to sell a security or if it is likely that the Company would be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ( OCI ). Impairment losses related to all other factors are presented as separate categories within OCI. The accretion of the amount recorded in OCI increases the carrying value of the investment and does not affect earnings. If there is an indication of additional credit losses the security is re-evaluated according to the procedures described above. No OTTI losses were recognized during the nine months ended September 30, 2012 and the year ended December 31, 2011.

**Restricted Equity Securities**

Restricted equity securities represent the Company's investment in the stock of the Federal Home Loan Bank of San Francisco ( FHLB ) and are carried at par value, which reasonably approximates its fair value. While technically these are considered equity securities, there is no market for the FHLB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates FHLB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

As a member of the FHLB system, the Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. The Company may request redemption at par value of any stock in excess of the minimum required investment. Stock redemptions are at the discretion of the FHLB.

**Loans Held for Sale**

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors of current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to noninterest income.

Mortgage loans held for sale are generally sold with the mortgage servicing rights retained by the Company. Gains or losses on the sale of loans that are held for sale are recognized at the time of the sale and determined by the difference between net sale proceeds and the net book value of the loans less the estimated fair value of any retained mortgage servicing rights.

**Loans and Allowance for Loan Losses**

Loans originated by the Company, i.e., not purchased or acquired in a business combination, are referred to as originated loans. Originated loans are reported at the principal amount outstanding, net of deferred loan fees and costs. Loan origination and commitment fees and certain direct

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loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loan's yield over the actual life of the loan. Originated loans on which the accrual of interest has been discontinued are designated as nonaccrual loans.

Originated loans are placed in nonaccrual status when reasonable doubt exists as to the full, timely collection of interest or principal, or a loan becomes contractually past due by 90 days or more with respect to interest or principal and is not well secured and in the process of collection. When an originated loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of Management, the loan is estimated to be fully collectible as to both principal and interest.



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An allowance for loan losses for originated loans is established through a provision for loan losses charged to expense. Originated loans and deposit related overdrafts are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely or, with respect to consumer installment loans, according to an established delinquency schedule. The allowance is an amount that Management believes will be adequate to absorb probable losses inherent in existing loans and leases, based on evaluations of the collectability, impairment and prior loss experience of loans and leases. The evaluations take into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The Company defines an originated loan as impaired when it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired originated loans are measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

In situations related to originated loans where, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession for other than an insignificant period of time to the borrower that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Company strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where the Company grants the borrower new terms that result in the loan being classified as a TDR, the Company measures any impairment on the restructuring as noted above for impaired loans. TDR loans are classified as impaired until they are fully paid off or charged off. Loans that are in nonaccrual status at the time they become TDR loans, remain in nonaccrual status until the borrower demonstrates a sustained period of performance which the Company generally believes to be six consecutive months of payments, or equivalent. Otherwise, TDR loans are subject to the same nonaccrual and charge-off policies as noted above with respect to their restructured principal balance.

Credit risk is inherent in the business of lending. As a result, the Company maintains an allowance for loan losses to absorb losses inherent in the Company's originated loan portfolio. This is maintained through periodic charges to earnings. These charges are included in the Consolidated Statements of Income as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. However, for a variety of reasons, not all losses are immediately known to the Company and, of those that are known, the full extent of the loss may not be quantifiable at that point in time. The balance of the Company's allowance for originated loan losses is meant to be an estimate of these unknown but probable losses inherent in the portfolio.

The Company formally assesses the adequacy of the allowance for originated loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding originated loan portfolio, and to a lesser extent the Company's originated loan commitments. These assessments include the periodic re-grading of credits based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment, growth of the portfolio as a whole or by segment, and other factors as warranted. Loans are initially graded when originated. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Company's method for assessing the appropriateness of the allowance for originated loan losses includes specific allowances for impaired originated loans and leases, formula allowance factors for pools of credits, and allowances for changing environmental factors (e.g., interest rates, growth, economic conditions, etc.). Allowance factors for loan pools were based on historical loss experience by product type and prior risk rating. During the three months ended March 31, 2012, management changed some of the assumptions utilized in the Allowance for Loan Losses estimate calculation. These changes were intended to more accurately reflect the current risk in the loan portfolio and to better estimate the losses inherent but not yet quantifiable. These changes included the conversion to a historical loss migration analysis intended to better determine the appropriate formula reserve ratio by loan category and risk rating, the addition of an environmental factor related to the delinquency rate of loans not classified as impaired by loan category, the elimination of an unspecified reserve allocation previously intended to account for imprecision inherent in the overall calculation, and the reclassification of risk rating of certain consumer loans based on current credit score in an attempt to better identify the risk in the portfolio. The financial effect of these changes resulted in a net reduction in the calculated Allowance for Loan Losses of \$1,388,000 during the three months ended March 31, 2012. Allowances for impaired loans are based on analysis of individual credits. Allowances for changing environmental factors are Management's best estimate of the probable impact these changes have had on the originated loan portfolio as a whole. The allowance for originated loans is included in the allowance for loan losses.

Loans purchased or acquired in a business combination are referred to as acquired loans. Acquired loans are valued as of acquisition date in accordance with Financial Accounting Standards Board Accounting Standards Codification ( FASB ASC ) Topic 805, *Business Combinations*. Loans acquired with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are referred to as purchased credit impaired (PCI) loans. PCI loans are accounted for under FASB ASC Topic 310-30, *Loans and*

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*Debt Securities Acquired with Deteriorated Credit Quality.* Under FASB ASC Topic 805 and FASB ASC Topic 310-30, PCI loans are recorded at fair value at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded as of the acquisition date. Fair value is defined as the present

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value of the future estimated principal and interest payments of the loan, with the discount rate used in the present value calculation representing the estimated effective yield of the loan. Default rates, loss severity, and prepayment speed assumptions are periodically reassessed and our estimate of future payments is adjusted accordingly. The difference between contractual future payments and estimated future payments is referred to as the nonaccretable difference. The difference between estimated future payments and the present value of the estimated future payments is referred to as the accretable yield. The accretable yield represents the amount that is expected to be recorded as interest income over the remaining life of the loan. If after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be more than the originally estimated, an increase in the discount rate (effective yield) would be made such that the newly increased accretable yield would be recognized, on a level yield basis, over the remaining estimated life of the loan. If, after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be less than the previously estimated, the discount rate would first be reduced until the present value of the reduced cash flow estimate equals the previous present value however, the discount rate may not be lowered below its original level at acquisition. If the discount rate has been lowered to its original level and the present value has not been sufficiently lowered, an allowance for loan loss would be established through a provision for loan losses charged to expense to decrease the present value to the required level. If the estimated cash flows improve after an allowance has been established for a loan, the allowance may be partially or fully reversed depending on the improvement in the estimated cash flows. Only after the allowance has been fully reversed may the discount rate be increased. PCI loans are put on nonaccrual status when cash flows cannot be reasonably estimated. PCI loans on nonaccrual status are accounted for using the cost recovery method or cash basis method of income recognition. PCI loans are charged off when evidence suggests cash flows are not recoverable. Foreclosed assets from PCI loans are recorded in foreclosed assets at fair value with the fair value at time of foreclosure representing cash flow from the loan. ASC 310-30 allows PCI loans with similar risk characteristics and acquisition time frame to be pooled and have their cash flows aggregated as if they were one loan. The Company elected to use the pooled method of ASC 310-30 for PCI other loans in the acquisition of certain assets and liabilities of Granite Community Bank ( Granite ) and Citizens Bank of Northern California ( Citizens ).

Acquired loans that are not PCI loans are referred to as purchased not credit impaired (PNCI) loans. PNCI loans are accounted for under FASB ASC Topic 310-20, *Receivables – Nonrefundable Fees and Other Costs*, in which interest income is accrued on a level-yield basis for performing loans. For income recognition purposes, this method assumes that all contractual cash flows will be collected, and no allowance for loan losses is established at the time of acquisition. Post-acquisition date, an allowance for loan losses may need to be established for acquired loans through a provision charged to earnings for credit losses incurred subsequent to acquisition. Under ASC 310-20, the loss would be measured based on the probable shortfall in relation to the contractual note requirements, consistent with our allowance for loan loss policy for similar loans.

When referring to PNCI and PCI loans we will use the terms nonaccretable difference , accretable yield , or purchase discount . Nonaccretable difference is the difference between undiscounted contractual cash flows due and undiscounted cash flows we expect to collect, or put another way, it is the undiscounted contractual cash flows we do not expect to collect. Accretable yield is the difference between undiscounted cash flows we expect to collect and the value at which we have recorded the loan on our financial statements. On the date of acquisition, all purchased loans are recorded on our consolidated financial statements at estimated fair value. Purchase discount is the difference between the estimated fair value of loans on the date of acquisition and the principal amount owed by the borrower, net of charge offs, on the date of acquisition. We may also refer to discounts to principal balance of loans owed, net of charge-offs . Discounts to principal balance of loans owed, net of charge-offs is the difference between principal balance of loans owed, net of charge-offs, and loans as recorded on our financial statements. Discounts to principal balance of loans owed, net of charge-offs arise from purchase discounts, and equal the purchase discount on the acquisition date.

Loans are also categorized as covered or noncovered . Covered loans refer to loans covered by a Federal Deposit Insurance Corporation ( FDIC ) loss sharing agreement. Noncovered loans refer to loans not covered by a FDIC loss sharing agreement.

### **Foreclosed Assets**

Foreclosed assets include assets acquired through, or in lieu of, loan foreclosure. Foreclosed assets are held for sale and are initially recorded at fair value less estimated costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, management periodically performs valuations and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense. Gain or loss on sale of foreclosed assets is included in noninterest income. Foreclosed assets that are not subject to a FDIC loss-share agreement are referred to as noncovered foreclosed assets.

Foreclosed assets acquired through FDIC-assisted acquisitions that are subject to a FDIC loss-share agreement, and all assets acquired via foreclosure of covered loans are referred to as covered foreclosed assets. Covered foreclosed assets are reported exclusive of expected reimbursement cash flows from the FDIC. Foreclosed covered loan collateral is transferred into covered foreclosed assets at the loan s carrying value, inclusive of the acquisition date fair value discount.

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Covered foreclosed assets are initially recorded at estimated fair value less estimated costs to sell on the acquisition date based on similar market comparable valuations less estimated selling costs. Any subsequent valuation adjustments due to declines in fair value will be charged to noninterest expense, and will be mostly offset by noninterest income representing the corresponding increase to the FDIC indemnification asset for the offsetting loss reimbursement amount. Any recoveries of previous valuation adjustments will be credited to noninterest expense with a corresponding charge to noninterest income for the portion of the recovery that is due to the FDIC.

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### **Premises and Equipment**

Land is carried at cost. Land improvements, buildings and equipment, including those acquired under capital lease, are stated at cost less accumulated depreciation and amortization. Depreciation and amortization expenses are computed using the straight-line method over the estimated useful lives of the related assets or lease terms. Asset lives range from 3-10 years for furniture and equipment and 15-40 years for land improvements and buildings.

### **Goodwill and Other Intangible Assets**

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and other intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment.

The Company has an identifiable intangible asset consisting of core deposit intangibles (CDI). CDI are amortized over their respective estimated useful lives, and reviewed for impairment.

### **Impairment of Long-Lived Assets and Goodwill**

Long-lived assets, such as premises and equipment, and purchased 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. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheet.

As of December 31 of each year, goodwill is tested for impairment, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level. The Company may choose to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, the Company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then goodwill is deemed not to be impaired. However, if the Company concludes otherwise, or if the Company elected not to first assess qualitative factors, then the Company performs the first step of a two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Currently, and historically, the Company is comprised of only one reporting unit that operates within the business segment it has identified as community banking.

### **Mortgage Servicing Rights**

Mortgage servicing rights (MSR) represent the Company's right to a future stream of cash flows based upon the contractual servicing fee associated with servicing mortgage loans. Our MSR arise from residential mortgage loans that we originate and sell, but retain the right to service the loans. The net gain from the retention of the servicing right is included in gain on sale of loans in noninterest income when the loan is sold. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. MSR are included in other assets. Servicing fees are recorded in noninterest income when earned.

We account for MSR at fair value. The determination of fair value of our MSR requires management judgment because they are not actively traded. The determination of fair value for MSR requires valuation processes which combine the use of discounted cash flow models and extensive analysis of current market data to arrive at an estimate of fair value. The cash flow and prepayment assumptions used in our

discounted cash flow model are based on empirical data drawn from the historical performance of our MSR, which we believe are consistent with assumptions used by market participants valuing similar MSR, and from data obtained on the performance of similar MSR. The key assumptions used in the valuation of MSR include mortgage prepayment speeds and the discount rate. These variables can, and generally will, change from quarter to quarter as market conditions and projected interest rates change. The key risks inherent with MSR are prepayment speed and changes in interest rates. The Company uses an independent third party to determine fair value of MSR.

**Indemnification Asset**

The Company has elected to account for amounts receivable under loss-share agreements with the FDIC as indemnification assets in accordance with FASB ASC Topic 805, *Business Combinations*. FDIC indemnification assets are initially recorded at fair value, based on

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the discounted value of expected future cash flows under the loss-share agreements. The difference between the fair value and the undiscounted cash flows the Company expects to collect from the FDIC will be accreted into noninterest income over the life of the FDIC indemnification asset. FDIC indemnification assets are reviewed quarterly and adjusted for any changes in expected cash flows based on recent performance and expectations for future performance of the covered portfolios. These adjustments are measured on the same basis as the related covered loans and covered other real estate owned. Any increases in cash flow of the covered assets over those expected will reduce the FDIC indemnification asset and any decreases in cash flow of the covered assets under those expected will increase the FDIC indemnification asset. Increases and decreases to the FDIC indemnification asset are recorded as adjustments to noninterest income.

**Reserve for Unfunded Commitments**

The reserve for unfunded commitments is established through a provision for losses unfunded commitments charged to noninterest expense. The reserve for unfunded commitments is an amount that Management believes will be adequate to absorb probable losses inherent in existing commitments, including unused portions of revolving lines of credits and other loans, standby letters of credits, and unused deposit account overdraft privilege. The reserve for unfunded commitments is based on evaluations of the collectability, and prior loss experience of unfunded commitments. The evaluations take into consideration such factors as changes in the nature and size of the loan portfolio, overall loan portfolio quality, loan concentrations, specific problem loans and related unfunded commitments, and current economic conditions that may affect the borrower's or depositor's ability to pay.

**Income Taxes**

The Company's accounting for income taxes is based on an asset and liability approach. The Company recognizes the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the future tax consequences that have been recognized in its financial statements or tax returns. The measurement of tax assets and liabilities is based on the provisions of enacted tax laws.

**Off-Balance Sheet Credit Related Financial Instruments**

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

**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.

**Reclassifications**

Certain amounts reported in previous consolidated financial statements have been reclassified to conform to the presentation in this report. These reclassifications did not affect previously reported net income or total shareholders' equity.

**Recent Accounting Pronouncements**

FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. This Update is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 was adopted by the Company on January 1, 2012 and did not have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011, and did not have a significant impact on the Company's consolidated financial statements.

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FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 is effective for annual periods beginning after December 15, 2011, and did not have a significant impact on the Company's consolidated financial statements.

FASB issued ASU 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. ASU 2011-08 amends Topic 350, Intangibles - Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the



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reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and did not have a significant impact on the Company's consolidated financial statements.

FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Update is not expected to have a significant impact on the Company's consolidated financial statements.

FASB issued ASU 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. ASU 2011-12 updates and supersedes certain pending paragraphs relating to the presentation on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. This Update is effective concurrent with ASU 2011-05, and did not have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*. ASU 2012-06 requires that when a reporting entity recognizes an indemnification asset (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution and subsequently a change in the cash flows expected to be collected on the indemnification asset occurs (as a result of a change in cash flows expected to be collected on the assets subject to indemnification), the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining life of the indemnified assets). This Update is effective for annual and interim impairment tests beginning after December 15, 2012, and is not expected to have a significant impact on the Company's consolidated financial statements.

**Table of Contents****Note 2 Business Combinations**

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 one administration building and 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.

The assets acquired and liabilities assumed for the Citizens acquisition have been accounted for under the acquisition method of accounting (formerly the purchase method). The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. The fair values of the assets acquired and liabilities assumed were determined based on the requirements of the Fair Value Measurements and Disclosures topic of the FASB ASC. The tax treatment of FDIC assisted acquisitions is complex and subject to interpretations that may result in future adjustments of deferred taxes as of the acquisition date. The terms of the agreement provide for the FDIC to indemnify the Bank against claims with respect to liabilities of Citizens not assumed by the Bank and certain other types of claims identified in the agreement. The application of the acquisition method of accounting resulted in the recognition of a bargain purchase gain of \$7,575,000 in the Citizens acquisition.

A summary of the net assets received in the Citizens acquisition, at their estimated fair values, is presented below:

(In thousands)	Citizens September 23, 2011
<b>Asset acquired:</b>	
Cash and cash equivalents	\$ 80,707
Securities available-for-sale	9,353
Restricted equity securities	1,926
Loans	167,484
Core deposit intangible	898
Foreclosed assets	8,412
Other assets	1,524
<b>Total assets acquired</b>	<b>\$ 270,304</b>
<b>Liabilities assumed:</b>	
Deposits	\$ 239,899
Other borrowings	22,038
Other liabilities	792
<b>Total liabilities assumed</b>	<b>262,729</b>
<b>Net assets acquired/bargain purchase gain</b>	<b>\$ 7,575</b>

In FDIC-assisted transactions, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer. In the Citizens acquisition, net assets with a cost basis of \$26,682,000 were transferred to the Bank. In the Citizens acquisition, the Company recorded a bargain purchase gain of \$7,575,000 representing the excess of the estimated fair value of the assets acquired over the estimated fair value of the liabilities assumed.

A summary of the estimated fair value adjustments resulting in the bargain purchase gain in the Citizens acquisition are presented below:

(In thousands)	Citizens September 23, 2011
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Cost basis net assets acquired	\$	26,682
Cash payment received from FDIC		44,140
Fair value adjustments:		
Cash and cash equivalents		539
Loans		(57,745)
Foreclosed assets		(5,609)
Core deposit intangible		898
Deposits		(382)
Borrowings		(28)
Other		(920)
<b>Bargain purchase gain</b>	<b>\$</b>	<b>7,575</b>

The Bank acquired only certain assets and assumed certain liabilities of Citizens. A significant portion of Citizens' operations, its facilities and its central operations and administrative functions were not retained by the Bank. Therefore, disclosure of supplemental pro forma financial information, especially prior period comparison is deemed neither practical nor meaningful given the troubled nature of Citizens prior to the date of acquisition. The Bank did not immediately acquire all the banking facilities, furniture or equipment of Citizens as part of the purchase and assumption agreement. However, the Bank had the option to lease the real estate and purchase the furniture and equipment from the FDIC. The term of this option expired 90 days from the acquisition date. Prior to the expiration of the option, the Bank agreed to purchase essentially all of the furniture and equipment, and assume all of the property leases except for the administration building and Citizen's Auburn branch. During the three months ended March 31, 2012, the Bank transferred the operations of Citizen's Auburn branch to the Bank's existing branch in Auburn, and vacated the Citizen's administration building.

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The Company identified the loans acquired in the Citizens acquisition as either PNCI or PCI loans. The Company identified certain of the Citizens PCI loans as having cash flows that were not reasonably estimable and elected to place these loans in nonaccrual status under the cash basis method for income recognition ( PCI cash basis loans). The Company elected to use the ASC 310-30 pooled method of accounting for all other Citizens PCI loans ( PCI other loans).

The following table presents a reconciliation of the undiscounted contractual cash flows, nonaccretable difference, accretable yield, fair value, purchase discount, and principal balance of loans for the various categories of Citizens PNCI and PCI loans as of the acquisition date. For PCI loans, the purchase discount does not necessarily represent cash flows to be collected as a portion of it is a nonaccretable difference:

(In thousands)	Citizens Loans September 23, 2011			Total
	PNCI	PCI other	PCI cash basis	
Undiscounted contractual cash flows	\$ 230,106	\$ 69,346	\$ 35,205	\$ 334,657
Undiscounted cash flows not expected to be collected (nonaccretable difference)		(26,846)	(24,517)	(51,363)
Undiscounted cash flows expected to be collected	230,106	42,500	10,688	283,294
Accretable yield at acquisition	(105,664)	(10,146)		(115,810)
Estimated fair value of loans acquired at acquisition	124,442	32,354	10,688	167,484
Purchase discount	20,364	23,207	14,174	57,745
Principal balance loans acquired	\$ 144,806	\$ 55,561	\$ 24,862	\$ 225,229

In estimating the fair value of Citizens PNCI loans at the acquisition date, the Company calculated the contractual amount and timing of undiscounted principal and interest payments on an individual loan basis and then discounted those cash flows using an appropriate market rate of interest adjusted for liquidity and credit loss risks inherent in each loan. The Citizens PNCI loans expected accretable yield above represents undiscounted interest, and along with the purchase discount, is accounted for using an effective interest method consistent with our accounting for originated loans.

In estimating the fair value of Citizens PCI cash basis loans at the acquisition date, the Company calculated the contractual amount and timing of undiscounted principal and interest payments and estimated the amount of undiscounted expected principal recovery using historic loss rates or estimated collateral values if applicable. The difference between these two amounts represents the nonaccretable difference. The Company used its estimate of the amount of undiscounted expected principal recovery as the fair value of the Citizens PCI cash basis loans, and placed these loans in nonaccrual status. Interest income and principal reductions on these PCI cash basis loans are recorded only when they are received. At each financial reporting date, the carrying value of each PCI cash basis loan is compared to an updated estimate of expected principal payment or recovery for each loan. To the extent that the loan carrying amount exceeds the updated expected principal payment or recovery, a provision for loan loss would be recorded as a charge to income and an allowance for loan loss established.

In estimating the fair value of Citizens PCI other loans at the acquisition date, the Company calculated the contractual amount and timing of undiscounted principal and interest payments and estimated the amount and timing of undiscounted expected principal and interest payments. The difference between these two amounts represents the nonaccretable difference. On the acquisition date, the amount by which the undiscounted expected cash flows exceed the estimated fair value of the acquired loans is the accretable yield. The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the loans. For PCI loans the accretable yield is accreted into interest income over the life of the estimated remaining cash flows. For further information regarding the accounting for PCI other loans, and acquired loans in general, see the discussion under the heading Loans and Allowance for Loan Losses in Note 1 above.

The operations of Citizens, included in the Company's operating results from September 23, 2011 to December 31, 2011, added approximately \$6,171,000 and \$54,000 to interest income and interest expense, respectively, \$1,462,000 to provision for loan losses, \$8,029,000 to noninterest income, including a bargain purchase gain of \$7,575,000, and \$1,865,000 to noninterest expense. Included in the \$6,171,000 of Citizens related interest income recorded from September 23, 2011 to December 31, 2011, is \$3,146,000 of interest income from fair value discount accretion. Such operating results are not necessarily indicative of future operating results. Citizens' results of operations prior to the acquisition are not included in the Company's operating results. As of December 31, 2011, nonrecurring expenses related to the Citizens acquisition were

insignificant.

During the three months ended March 31, 2012, the Company completed the conversion of Citizens' information and data processing systems to the Bank's systems, and consolidated the Citizens Auburn branch into the Bank's existing Auburn branch. The operations of Citizens, included in the Company's operating results from January 1, 2012 to March 31, 2012, added approximately \$4,464,000 and \$8,000 to interest income and interest expense, respectively, \$1,467,000 to provision for loan losses, \$145,000 to noninterest income, and \$2,151,000 to noninterest expense. Included in the \$4,464,000 of Citizens related interest income recorded from January 1, 2012 to March 31,

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2012, is \$1,972,000 of interest income from fair value discount accretion. Included in the \$145,000 of Citizens related noninterest income recorded from January 1, 2012 to March 31, 2012, is a \$230,000 loss on disposal of fixed assets related to the system conversion noted above. Included in the \$2,151,000 of Citizens related noninterest expense recorded from January 1, 2012 to March 31, 2012, is \$415,000 of outside data processing expenses related to the system conversion noted above. Such operating results are not necessarily indicative of future operating results. Citizens' results of operations prior to the acquisition are not included in the Company's operating results.

The operations of Citizens, included in the Company's operating results from April 1, 2012 to June 30, 2012, added approximately \$5,152,000 and \$5,000 to interest income and interest expense, respectively, \$281,000 to provision for loan losses, \$643,000 to noninterest income, and \$1,534,000 to noninterest expense. Included in the \$5,152,000 of Citizens related interest income recorded from April 1, 2012 to June 30, 2012, is \$2,278,000 of interest income from fair value discount accretion. Such operating results are not necessarily indicative of future operating results. Citizens' results of operations prior to the acquisition are not included in the Company's operating results.

The operations of Citizens, included in the Company's operating results from July 1, 2012 to September 30, 2012, added approximately \$4,130,000 and \$79,000 to interest income and interest expense, respectively, \$529,000 to provision for loan losses, \$574,000 to noninterest income, and \$1,170,000 to noninterest expense. Included in the \$4,130,000 of Citizens related interest income recorded from July 1, 2012 to September 30, 2012, is \$1,658,000 of interest income from fair value discount accretion. Such operating results are not necessarily indicative of future operating results. Citizens' results of operations prior to the acquisition are not included in the Company's operating results.

**Note 3 Investment Securities**

The amortized cost and estimated fair values of investments in debt and equity securities are summarized in the following tables:

	Amortized Cost	September 30, 2012		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
<b>Securities Available-for-Sale</b>				
Obligations of U.S. government corporations and agencies	\$ 161,785	\$ 9,794		\$ 171,579
Obligations of states and political subdivisions	9,562	389		9,951
Corporate debt securities	1,859	43		1,902
<b>Total securities available-for-sale</b>	<b>\$ 173,206</b>	<b>\$ 10,226</b>		<b>\$ 183,432</b>

	Amortized Cost	December 31, 2011		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
<b>Securities Available-for-Sale</b>				
Obligations of U.S. government corporations and agencies	\$ 207,284	\$ 10,100		\$ 217,384
Obligations of states and political subdivisions	9,561	467		10,028
Corporate debt securities	1,848		\$ (37)	1,811
<b>Total securities available-for-sale</b>	<b>\$ 218,693</b>	<b>\$ 10,567</b>	<b>\$ (37)</b>	<b>\$ 229,223</b>

No investment securities were sold during the nine months ended September 30, 2012 or the year ended December 31, 2011. Investment securities with an aggregate carrying value of \$59,347,000 and \$110,763,000 at September 30, 2012 and December 31, 2011, respectively, were pledged as collateral for specific borrowings, lines of credit and local agency deposits.



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The amortized cost and estimated fair value of debt securities at September 30, 2012 by contractual maturity are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. At September 30, 2012, obligations of U.S. government corporations and agencies with a cost basis totaling \$161,785,000 consist almost entirely of mortgage-backed securities whose contractual maturity, or principal repayment, will follow the repayment of the underlying mortgages. For purposes of the following table, the entire outstanding balance of these mortgage-backed securities issued by U.S. government corporations and agencies is categorized based on final maturity date. At September 30, 2012, the Company estimates the average remaining life of these mortgage-backed securities issued by U.S. government corporations and agencies to be approximately 3.3 years. Average remaining life is defined as the time span after which the principal balance has been reduced by half.

	Amortized Cost	Estimated Fair Value
	(In thousands)	
<b>Investment Securities</b>		
Due in one year	\$ 2,340	\$ 2,425
Due after one year through five years	8,745	9,207
Due after five years through ten years	53,086	55,291
Due after ten years	109,035	116,509
 Totals	 \$ 173,206	 \$ 183,432

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
<b>September 30, 2012:</b>						
<b>Securities Available-for-Sale:</b>						
Obligations of U.S. government corporations and agencies						
Obligations of states and political subdivisions						
Corporate debt securities						

Total securities available-for-sale

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
<b>December 31, 2011</b>						
<b>Securities Available-for-Sale:</b>						
Obligations of U.S. government corporations and agencies	\$ 10				\$ 10	
Obligations of states and political subdivisions						
Corporate debt securities	1,811	\$ (37)			1,811	\$ (37)
 Total securities available-for-sale	 \$ 1,821	 \$ (37)			 \$ 1,821	 \$ (37)



Obligations of U.S. government corporations and agencies: Unrealized losses on investments in obligations of U.S. government corporations and agencies are caused by interest rate increases. The contractual cash flows of these securities are guaranteed by U.S. Government Sponsored Entities (principally Fannie Mae and Freddie Mac). It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell and more likely than not will not be required to sell, these investments are not considered other-than-temporarily impaired. At September 30, 2012, no debt securities had an unrealized loss.

**Table of Contents****Note 4 Loans**

A summary of loan balances follows (in thousands):

	September 30, 2012				
	Originated	PNCI	PCI Cash basis	PCI Other	Total
<b>Mortgage loans on real estate:</b>					
Residential 1-4 family	\$ 120,683	\$ 7,304		\$ 6,054	\$ 134,041
Commercial	765,367	75,490	1,345	31,189	873,391
<b>Total mortgage loan on real estate</b>	<b>886,050</b>	<b>82,794</b>	<b>1,345</b>	<b>37,243</b>	<b>1,007,432</b>
<b>Consumer:</b>					
Home equity lines of credit	311,749	17,184	8,082	5,883	342,898
Home equity loans	13,734	332	48	156	14,270
Auto Indirect	5,067				5,067
Other	23,933	2,653		23	26,609
<b>Total consumer loans</b>	<b>354,483</b>	<b>20,169</b>	<b>8,130</b>	<b>6,062</b>	<b>388,844</b>
<b>Commercial</b>	<b>132,162</b>	<b>1,021</b>	<b>1,905</b>	<b>10,381</b>	<b>145,469</b>
<b>Construction:</b>					
Residential	10,574			7,758	18,332
Commercial	12,044			3,526	15,570
<b>Total construction</b>	<b>22,618</b>			<b>11,284</b>	<b>33,902</b>
<b>Total loans, net of deferred loan fees</b>	<b>\$ 1,395,313</b>	<b>\$ 103,984</b>	<b>\$ 11,380</b>	<b>\$ 64,970</b>	<b>\$ 1,575,647</b>
<b>Total principal balance of loans owed, net of charge-offs</b>	<b>\$ 1,397,637</b>	<b>\$ 119,264</b>	<b>\$ 23,552</b>	<b>\$ 80,201</b>	<b>\$ 1,620,654</b>
Unamortized net deferred loan fees	(2,324)				(2,324)
Discounts to principal balance of loans owed, net of charge-offs		(15,280)	(12,172)	(15,231)	(42,683)
<b>Total loans, net of unamortized deferred loan fees</b>	<b>\$ 1,395,313</b>	<b>\$ 103,984</b>	<b>\$ 11,380</b>	<b>\$ 64,970</b>	<b>\$ 1,575,647</b>
<b>Noncovered loans</b>	<b>\$ 1,395,313</b>	<b>\$ 103,984</b>	<b>\$ 11,380</b>	<b>\$ 22,350</b>	<b>\$ 1,533,027</b>
<b>Covered loans</b>				<b>42,620</b>	<b>42,620</b>
<b>Total loans, net of unamortized deferred loan fees</b>	<b>\$ 1,395,313</b>	<b>\$ 103,984</b>	<b>\$ 11,380</b>	<b>\$ 64,970</b>	<b>\$ 1,575,647</b>
<b>Allowance for loan loss</b>	<b>\$ (38,207)</b>	<b>\$ (1,059)</b>	<b>\$ (1,349)</b>	<b>\$ (3,531)</b>	<b>\$ (44,146)</b>

**Table of Contents****Note 4 Loans (continued)**

A summary of loan balances follows (in thousands):

	December 31, 2011				
	Originated	PNCI	PCI Cash basis	PCI Other	Total
<b>Mortgage loans on real estate:</b>					
Residential 1-4 family	\$ 118,320	\$ 14,750		\$ 6,516	\$ 139,586
Commercial	699,682	93,428		33,226	826,336
<b>Total mortgage loan on real estate</b>	<b>818,002</b>	<b>108,178</b>		<b>39,742</b>	<b>965,922</b>
<b>Consumer:</b>					
Home equity lines of credit	321,834	20,902	\$ 8,615	5,954	357,305
Home equity loans	14,320	367		157	14,844
Auto Indirect	10,821				10,821
Other	20,270	3,041		49	23,360
<b>Total consumer loans</b>	<b>367,245</b>	<b>24,310</b>	<b>8,615</b>	<b>6,160</b>	<b>406,330</b>
Commercial	123,486	1,805	811	13,029	139,131
<b>Construction:</b>					
Residential	13,908			8,214	22,122
Commercial	12,744			4,783	17,527
<b>Total construction</b>	<b>26,652</b>			<b>12,997</b>	<b>39,649</b>
<b>Total loans, net of deferred loan fees</b>	<b>\$ 1,335,385</b>	<b>\$ 134,293</b>	<b>\$ 9,426</b>	<b>\$ 71,928</b>	<b>\$ 1,551,032</b>
<b>Total principal balance of loans owed, net of charge-offs</b>	<b>\$ 1,337,693</b>	<b>\$ 152,549</b>	<b>\$ 22,137</b>	<b>\$ 94,660</b>	<b>\$ 1,607,039</b>
Unamortized net deferred loan fees	(2,308)				(2,308)
Discounts to principal balance of loans owed, net of charge-offs		(18,256)	(12,711)	(22,732)	(53,699)
<b>Total loans, net of unamortized deferred loan fees</b>	<b>\$ 1,335,385</b>	<b>\$ 134,293</b>	<b>\$ 9,426</b>	<b>\$ 71,928</b>	<b>\$ 1,551,032</b>
<b>Noncovered loans</b>	<b>\$ 1,335,385</b>	<b>\$ 134,293</b>	<b>\$ 9,426</b>	<b>\$ 22,857</b>	<b>\$ 1,501,961</b>
Covered loans				49,071	49,071
<b>Total loans, net of unamortized deferred loan fees</b>	<b>\$ 1,335,385</b>	<b>\$ 134,293</b>	<b>\$ 9,426</b>	<b>\$ 71,928</b>	<b>\$ 1,551,032</b>
<b>Allowance for loan loss</b>	<b>\$ (41,458)</b>	<b>\$ (245)</b>	<b>\$ (1,034)</b>	<b>\$ (3,177)</b>	<b>\$ (45,914)</b>

The following is a summary of the change in accretable yield for PCI other loans during the periods indicated (in thousands):

	Three months ended Sept. 30, 2012	Three months ended Sept. 30, 2011	Nine months ended Sept. 30, 2012	Nine months ended Sept. 30, 2011
<b>Change in accretable yield:</b>				
Balance at beginning of period	\$ 23,732	\$ 13,457	\$ 25,145	\$ 17,717

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Acquisitions		10,146		10,146
Accretion to interest income	(2,037)	(1,408)	(5,921)	(3,436)
Reclassification (to) from Nonaccretable difference	2,385	1,433	4,856	(799)
Balance at end of period	\$ 24,080	\$ 23,628	\$ 24,080	\$ 23,628

Throughout these consolidated financial statements, and in particular in this Note 4 and Note 5, when we refer to Loans or Allowance for loan losses we mean all categories of loans, including Originated, PNCI, PCI cash basis, and PCI other. When we are not referring to all categories of loans, we will indicate which we are referring to Originated, PNCI, PCI cash basis, or PCI other.

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**Note 5 Allowance for Loan Losses**

The following tables summarize the activity in the allowance for loan losses, and ending balance of loans, net of unearned fees for the periods indicated.

(In thousands)	Allowance for Loan Losses Three months ended September 30, 2012									
	RE Mortgage		Home Equity		Auto	Other	C&I	Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consum.		Resid.	Comm.	
Beginning balance	\$ 3,458	\$ 9,566	\$ 21,602	\$ 1,159	\$ 433	\$ 621	\$ 5,694	\$ 1,679	\$ 1,637	\$ 45,849
Charge-offs	(370)	(340)	(1,636)	(12)	(12)	(280)	(625)		(93)	(3,368)
Recoveries		181	160	6	72	211	91	412		1,133
Provision	492	630	1,176	100	(161)	132	(389)	(802)	(646)	532
Ending balance	\$ 3,580	\$ 10,037	\$ 21,302	\$ 1,253	\$ 332	\$ 684	\$ 4,771	\$ 1,289	\$ 898	\$ 44,146

(In thousands)	Allowance for Loan Losses Nine months ended September 30, 2012									
	RE Mortgage		Home Equity		Auto	Other	C&I	Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consum.		Resid.	Comm.	
Beginning balance	\$ 2,404	\$ 13,217	\$ 18,258	\$ 1,101	\$ 215	\$ 932	\$ 6,545	\$ 1,817	\$ 1,425	\$ 45,914
Charge-offs	(918)	(2,008)	(6,739)	(170)	(83)	(928)	(1,202)	(362)	(68)	(12,478)
Recoveries	27	999	307	15	171	653	227	412		2,811
Provision	2,067	(2,171)	9,476	307	29	27	(799)	(578)	(459)	7,899
Ending balance	\$ 3,580	\$ 10,037	\$ 21,302	\$ 1,253	\$ 332	\$ 684	\$ 4,771	\$ 1,289	\$ 898	\$ 44,146

**Ending balance:**

Individ. evaluated for impairment	\$ 794	\$ 1,234	\$ 2,140	\$ 174	\$ 9	\$ 45	\$ 773	\$ 40	\$ 550	\$ 5,759
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Loans pooled for evaluation	\$ 2,415	\$ 8,239	\$ 17,899	\$ 999	\$ 324	\$ 640	\$ 2,445	\$ 465	\$ 81	\$ 33,507
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**Loans acquired with**

deteriorated credit quality	\$ 371	\$ 564	\$ 1,263	\$ 79			\$ 1,553	\$ 783	\$ 267	\$ 4,880
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(In thousands)	Loans, net of unearned fees As of September 30, 2012									
	RE Mortgage		Home Equity		Auto	Other	C&I	Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consum.		Resid.	Comm.	
Ending balance:										
Total loans	\$ 134,041	\$ 873,391	\$ 342,898	\$ 14,270	\$ 5,067	\$ 26,609	\$ 145,469	\$ 18,332	\$ 15,570	\$ 1,575,647
Individ. evaluated for impairment	\$ 9,285	\$ 68,887	\$ 9,946	\$ 683	\$ 260	\$ 136	\$ 8,696	\$ 4,126	\$ 6,955	\$ 108,974
Loans pooled for evaluation	\$ 118,702	\$ 771,971	\$ 318,987	\$ 13,383	\$ 4,807	\$ 26,450	\$ 124,487	\$ 6,448	\$ 5,089	\$ 1,390,324
Loans acquired with deteriorated	\$ 6,054	\$ 32,533	\$ 13,965	\$ 204		\$ 23	\$ 12,286	\$ 7,758	\$ 3,526	\$ 76,349

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credit quality

(In thousands)	RE Mortgage		Home Equity		Auto		Other		Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consum.	C&I	Resid.	Comm.		
<b>Ending balance:</b>											
Total loans	\$ 139,586	\$ 826,336	\$ 357,305	\$ 14,844	\$ 10,821	\$ 23,360	\$ 139,131	\$ 22,122	\$ 17,527	\$ 1,551,032	
<b>Individ. evaluated for impairment</b>											
	\$ 10,167	\$ 71,893	\$ 9,388	\$ 661	\$ 571	\$ 109	\$ 9,526	\$ 5,627	\$ 6,899	\$ 114,841	
<b>Loans pooled for evaluation</b>											
	\$ 122,903	\$ 721,217	\$ 333,348	\$ 14,026	\$ 10,250	\$ 23,202	\$ 115,765	\$ 8,281	\$ 5,845	\$ 1,354,837	
<b>Loans acquired with deteriorated credit quality</b>											
	\$ 6,516	\$ 33,226	\$ 14,569	\$ 157		\$ 49	\$ 13,840	\$ 8,214	\$ 4,783	\$ 81,354	

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**Note 5 Allowance for Loan Losses (continued)**

The following tables summarize the activity in the allowance for loan losses, and ending balance of loans, net of unearned fees for the periods indicated.

(In thousands)	Allowance for Loan Losses Three months ended September 30, 2011									
	RE Mortgage		Home Equity		Auto	Other	Construction			Total
	Resid.	Comm.	Lines	Loans	Indirect	Consumer	C&I	Resid.	Comm.	
Beginning balance	\$ 2,521	\$ 13,419	\$ 16,480	\$ 1,171	\$ 384	\$ 822	\$ 6,812	\$ 1,697	\$ 656	\$ 43,962
Charge-offs	(170)	(1,176)	(1,860)	(287)	(105)	(325)	(449)		(56)	(4,428)
Recoveries	9	24	210	29	76	266	80	3		697
Provision	487	934	2,11	174	(48)	122	574	748	(43)	5,069
Ending balance	\$ 2,847	\$ 13,2012	\$ 16,951	\$ 1,087	\$ 307	\$ 885	\$ 7,017	\$ 2,448	\$ 557	\$ 45,300

(In thousands)	Allowance for Loan Losses Nine months ended September 30, 2011									
	RE Mortgage		Home Equity		Auto	Other	Construction			Total
	Resid.	Comm.	Lines	Loans	Indirect	Consumer	C&I	Resid.	Comm.	
Beginning balance	\$ 3,007	\$ 12,700	\$ 15,054	\$ 795	\$ 1,229	\$ 701	\$ 5,991	\$ 1,824	\$ 1,270	\$ 42,571
Charge-offs	(1,616)	(3,165)	(7,389)	(551)	(340)	(858)	(2,207)	(430)	(151)	(16,707)
Recoveries	121	90	457	31	259	640	142	25	40	1,805
Provision	1,335	3,576	8,829	812	(841)	402	3,091	1,029	(602)	17,631
Ending balance	\$ 2,847	\$ 13,201	\$ 16,951	\$ 1,087	\$ 307	\$ 885	\$ 7,017	\$ 2,448	\$ 557	\$ 45,300

Ending balance:

Individ. evaluated for impairment	\$ 920	\$ 1,329	\$ 1,577	\$ 92	\$ 76	\$ 21	\$ 260	\$ 326	\$ 481	\$ 5,082
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Loans pooled for evaluation	\$ 1,907	\$ 11,709	\$ 14,773	\$ 995	\$ 231	\$ 864	\$ 4,935	\$ 1,739	\$ 76	\$ 37,229
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Loans acquired with

deteriorated credit quality	\$ 20	\$ 163	\$ 601				\$ 1,822	\$ 383		\$ 2,989
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(In thousands)	Loans, net of unearned fees As of September 30, 2011									
	RE Mortgage		Home Equity		Auto	Other	Construction			Total
	Resid.	Comm.	Lines	Loans	Indirect	Consumer	C&I	Resid.	Comm.	
Ending balance:										
Total loans	\$ 140,815	\$ 826,516	\$ 357,877	\$ 15,282	\$ 13,551	\$ 22,755	\$ 151,882	\$ 28,802	\$ 18,147	\$ 1,575,627

Individ.

evaluated for impairment	\$ 9,835	\$ 68,348	\$ 7,686	\$ 556	\$ 804	\$ 104	\$ 8,032	\$ 6,126	\$ 7,287	\$ 108,778
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Loans pooled

for evaluation	\$ 124,461	\$ 720,418	\$ 335,179	\$ 14,570	\$ 12,747	\$ 22,597	\$ 128,051	\$ 11,698	\$ 7,629	\$ 1,377,350
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Loans acquired with deteriorated credit quality	\$	6,519	\$	37,750	\$	15,012	\$	156		\$	54	\$	15,799	\$	10,978	\$	3,231	\$	89,499
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**Table of Contents****Note 5 Allowance for Loan Losses (continued)**

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including, but not limited to, trends relating to (i) the level of criticized and classified loans, (ii) net charge-offs, (iii) non-performing loans, and (iv) delinquency within the portfolio.

The Company utilizes a risk grading system to assign a risk grade to each of its loans. Loans are graded on a scale ranging from Pass to Loss. A description of the general characteristics of the risk grades is as follows:

*Pass* This grade represents loans ranging from acceptable to very little or no credit risk. These loans typically meet most if not all policy standards in regard to: loan amount as a percentage of collateral value, debt service coverage, profitability, leverage, and working capital.

*Special Mention* This grade represents *Other Assets Especially Mentioned* in accordance with regulatory guidelines and includes loans that display some potential weaknesses which, if left unaddressed, may result in deterioration of the repayment prospects for the asset or may inadequately protect the Company's position in the future. These loans warrant more than normal supervision and attention.

*Substandard* This grade represents *Substandard* loans in accordance with regulatory guidelines. Loans within this rating typically exhibit weaknesses that are well defined to the point that repayment is jeopardized. Loss potential is, however, not necessarily evident. The underlying collateral supporting the credit appears to have sufficient value to protect the Company from loss of principal and accrued interest, or the loan has been written down to the point where this is true. There is a definite need for a well defined workout/rehabilitation program.

*Doubtful* This grade represents *Doubtful* loans in accordance with regulatory guidelines. An asset classified as *Doubtful* has all the weaknesses inherent in a loan classified *Substandard* with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral, and financing plans.

*Loss* This grade represents *Loss* loans in accordance with regulatory guidelines. A loan classified as *Loss* is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan, even though some recovery may be affected in the future. The portion of the loan that is graded loss should be charged off no later than the end of the quarter in which the loss is identified.

The following tables present ending loan balances by loan category and risk grade as of the dates indicated:

(In thousands)	RE Mortgage		Credit Quality Indicators			As of September 30, 2012		Construction		Total
	Resid.	Comm.	Home Equity Lines	Loans	Auto Indirect	Other Consumer	C&I	Resid.	Comm.	
<b>Originated loans:</b>										
Pass	\$ 106,371	\$ 670,004	\$ 292,230	\$ 12,413	\$ 4,047	\$ 22,932	\$ 120,976	\$ 6,021	\$ 4,738	\$ 1,239,732
Special mention	2,598	26,900	6,797	692	566	855	2,883	285	538	42,114
Substandard	11,714	68,463	12,722	629	454	146	8,303	4,268	6,768	113,467
Loss										

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Total Originated loans	\$ 120,683	\$ 765,367	\$ 311,749	\$ 13,734	\$ 5,067	\$ 23,933	\$ 132,162	\$ 10,574	\$ 12,044	\$ 1,395,313
PNCI loans:										
Pass	\$ 6,648	\$ 67,199	\$ 16,015	\$ 332		\$ 2,474	1,016			\$ 93,684
Special mention		4,926	258			99	5			5,288
Substandard	656	3,365	911			80				5,012
Loss										
Total PNCI loans	\$ 7,304	\$ 75,490	\$ 17,184	\$ 332		\$ 2,653	\$ 1,021			\$ 103,984
PCI loans	\$ 6,054	\$ 32,534	\$ 13,965	\$ 204		\$ 23	\$ 12,286	\$ 7,758	\$ 3,526	\$ 76,350
Total loans	\$ 134,041	\$ 873,391	\$ 342,898	\$ 14,270	\$ 5,067	\$ 26,609	\$ 145,469	\$ 18,332	\$ 15,570	\$ 1,575,647

**Table of Contents****Note 5 Allowance for Loan Losses (Continued)**

(In thousands)	RE Mortgage		Credit Quality Indicators			As of December 31, 2011		Construction		Total
	Resid.	Comm.	Home Equity Lines	Loans	Auto Indirect	Other Consumer	C&I	Resid.	Comm.	
<b>Originated loans:</b>										
Pass	\$ 103,611	\$ 574,167	\$ 305,290	\$ 13,478	\$ 9,686	\$ 19,871	\$ 107,877	\$ 6,872	\$ 5,387	\$ 1,146,239
Special mention	1,020	46,518	1,295		33	10	6,709	903	430	56,918
Substandard	13,689	78,997	15,249	842	1,102	389	8,900	6,133	6,927	132,228
<b>Total Originated loans</b>	<b>\$ 118,320</b>	<b>\$ 699,682</b>	<b>\$ 321,834</b>	<b>\$ 14,320</b>	<b>\$ 10,821</b>	<b>\$ 20,270</b>	<b>\$ 123,486</b>	<b>\$ 13,908</b>	<b>\$ 12,744</b>	<b>\$ 1,335,385</b>
<b>PNCI loans:</b>										
Pass	\$ 14,576	\$ 83,735	\$ 20,053	\$ 367		\$ 3,034	\$ 1,707			\$ 123,472
Special mention		9,693	548			4				10,245
Substandard	174		301			3	98			576
<b>Total PNCI loans</b>	<b>\$ 14,750</b>	<b>\$ 93,428</b>	<b>\$ 20,902</b>	<b>\$ 367</b>		<b>\$ 3,041</b>	<b>\$ 1,805</b>			<b>\$ 134,293</b>
<b>PCI loans</b>	<b>\$ 6,516</b>	<b>\$ 33,226</b>	<b>\$ 14,569</b>	<b>\$ 157</b>		<b>\$ 49</b>	<b>\$ 13,840</b>	<b>\$ 8,214</b>	<b>\$ 4,783</b>	<b>\$ 81,354</b>
<b>Total loans</b>	<b>\$ 139,586</b>	<b>\$ 826,336</b>	<b>\$ 357,305</b>	<b>\$ 14,844</b>	<b>\$ 10,821</b>	<b>\$ 23,360</b>	<b>\$ 139,131</b>	<b>\$ 22,122</b>	<b>\$ 17,527</b>	<b>\$ 1,551,032</b>

Consumer loans, whether unsecured or secured by real estate, automobiles, or other personal property, are primarily susceptible to three primary risks; non-payment due to income loss, over-extension of credit and, when the borrower is unable to pay, shortfall in collateral value. Typically non-payment is due to loss of job and will follow general economic trends in the marketplace driven primarily by rises in the unemployment rate. Loss of collateral value can be due to market demand shifts, damage to collateral itself or a combination of the two.

Problem consumer loans are generally identified by payment history of the borrower (delinquency) or significant changes in the borrower's credit rating. Current credit scores are obtained for all consumer loans on a quarterly basis, and risk ratings are adjusted appropriately. The Bank manages its consumer loan portfolios by monitoring delinquency and contacting borrowers to encourage repayment, suggest modifications if appropriate, and, when continued scheduled payments become unrealistic, initiate repossession or foreclosure through appropriate channels. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, public value information (blue book values for autos), sales invoices, or other appropriate means. Appropriate valuations are obtained at initiation of the credit and periodically (every 3-12 months depending on collateral type) once repayment is questionable and the loan has been classified.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the business conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual fortunes of the business owner, and general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often these shifts are a result of changes in general economic or market conditions or overbuilding and resultant over-supply. Losses are dependent on value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs.

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Construction loans, whether owner occupied or non-owner occupied commercial real estate loans or residential development loans, are not only susceptible to the related risks described above but the added risks of construction itself including cost over-runs, mismanagement of the project, or lack of demand or market changes experienced at time of completion. Again, losses are primarily related to underlying collateral value and changes therein as described above.

Problem commercial loans are generally identified by periodic review of financial information which may include financial statements, tax returns, rent rolls and payment history of the borrower (delinquency). Based on this information the Bank may decide to take any of several courses of action including demand for repayment, additional collateral or guarantors, and, when repayment becomes unlikely through borrower's income and cash flow, repossession or foreclosure of the underlying collateral.

Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, public value information (blue book values for autos), sales invoices, or other appropriate means. Appropriate valuations are obtained at initiation of the credit and periodically (every 3-12 months depending on collateral type) once repayment is questionable and the loan has been classified.

Once a loan becomes delinquent and repayment becomes questionable, a Bank collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its

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probable loss, using a recent valuation as appropriate to the underlying collateral less estimated costs of sale, and charge the loan down to the estimated net realizable amount. Depending on the length of time until ultimate collection, the Bank may revalue the underlying collateral and take additional charge-offs as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when collateral is liquidated and actual loss is known. Unpaid balances on loans after or during collection and liquidation may also be pursued through lawsuit and attachment of wages or judgment liens on borrower's other assets.

The following table shows the ending balance of current, past due, and nonaccrual originated loans by loan category as of the date indicated:

(In thousands)	Analysis of Past Due and Nonaccrual Originated Loans As of September 30, 2012									
	RE Mortgage		Home Equity		Auto	Other	C&I	Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consumer		Resid.	Comm.	
Originated loan balance:										
Past due:										
30-59 Days	\$ 152	\$ 2,350	\$ 1,943	\$ 131	\$ 123	\$ 40	\$ 497	\$ 69		\$ 5,305
60-89 Days	499	7,551	1,016	55	15	30	150			9,316
> 90 Days	1,828	10,510	3,251	333	86	11	5,361	138	\$ 255	21,773
Total past due	2,479	20,411	6,210	519	224	81	6,008	207	255	36,394
Current	118,204	744,956	305,539	13,215	4,843	23,852	126,154	10,367	11,789	1,358,919
Total Originated loans	\$ 120,683	\$ 765,367	\$ 311,749	\$ 13,734	\$ 5,067	\$ 23,933	\$ 132,162	\$ 10,574	\$ 12,044	\$ 1,395,313
> 90 Days and still accruing	\$ 189									\$ 189
Nonaccrual loans	\$ 6,899	\$ 39,417	\$ 8,075	\$ 620	\$ 225	\$ 62	\$ 6,820	\$ 3,798	\$ 549	\$ 66,465

The following table shows the ending balance of current, past due, and nonaccrual PNCI loans by loan category as of the date indicated:

(In thousands)	Analysis of Past Due and Nonaccrual PNCI Loans As of September 30, 2012									
	RE Mortgage		Home Equity		Auto	Other	C&I	Construction		Total
	Resid.	Comm.	Lines	Loans	Indirect	Consumer		Resid.	Comm.	
PNCI loan balance:										
Past due:										
30-59 Days			\$ 339				\$ 8			\$ 347
60-89 Days				\$ 67			3	\$ 64		134
> 90 Days		\$ 261	213	377						851
Total past due		261	552	444			11	64		1,332
Current		7,043	74,938	16,740	332		2,642	957		102,652
Total PNCI loans		\$ 7,304	\$ 75,490	\$ 17,184	\$ 332		\$ 2,653	\$ 1,021		\$ 103,984
> 90 Days and still accruing		\$ 63	\$ 310							\$ 373
Nonaccrual loans		\$ 271	\$ 2,497	\$ 392			\$ 44			\$ 3,204

The following table shows the ending balance of current, past due, and nonaccrual originated loans by loan category as of the date indicated:

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(In thousands)	Analysis of Past Due and Nonaccrual Originated Loans							As of December 31, 2011		Total
	RE Mortgage		Home Equity		Auto	Other	Construction			
	Resid.	Comm.	Lines	Loans	Indirect	Consumer	C&I	Resid.	Comm.	
Originated loan balance:										
Past due:										
30-59 Days	\$ 1,715	\$ 7,509	\$ 2,586	\$ 52	\$ 181	\$ 46	\$ 683	\$ 921		\$ 13,693
60-89 Days	750	1,171	2,629	281	56	153	1,334	92		6,466
> 90 Days	3,279	9,892	3,129	114	130	5	4,929	2,088		23,566
Total past due	5,744	18,572	8,344	447	367	204	6,946	3,101		43,725
Current										