

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

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018

Commission file number: 000-33063

Sierra Bancorp

(Exact name of Registrant as specified in its charter)

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

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

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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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large Accelerated Filer	Accelerated Filer:
Non accelerated Filer:	Smaller Reporting Company:
Emerging Growth Company:	

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

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

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

Common stock, no par value, 15,283,310 shares outstanding as of November 1, 2018

FORM 10-Q

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PART I - FINANCIAL INFORMATION

Item 1 – Financial Statements

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

	September 30, 2018 (unaudited)	December 31, 2017 (audited)
ASSETS		
Cash and due from banks	\$59,190	\$61,142
Interest-bearing deposits in banks	5,849	8,995
Total cash & cash equivalents	65,039	70,137
Securities available-for-sale	548,815	558,329
Loans and leases:		
Gross loans and leases	1,694,509	1,557,820
Allowance for loan and lease losses	(9,463)	(9,043)
Deferred loan and lease costs, net	2,603	2,774
Net loans and leases	1,687,649	1,551,551
Foreclosed assets	2,212	5,481
Premises and equipment, net	29,998	29,388
Goodwill	27,357	27,357
Other intangible assets, net	6,724	6,234
Company owned life insurance	48,559	47,108
Other assets	46,687	44,713
Total assets	\$2,463,040	\$2,340,298
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	\$685,941	\$635,434
Interest bearing	1,420,112	1,352,952
Total deposits	2,106,053	1,988,386
Repurchase agreements	16,522	8,150
Short-term borrowings	16,100	21,900
Subordinated debentures, net	34,722	34,588
Other liabilities	26,435	31,332
Total liabilities	2,199,832	2,084,356
Commitments and contingent liabilities (Note 8)		
Shareholders' equity		
Common stock, no par value; 24,000,000 shares authorized; 15,277,710 and 15,223,360 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	112,079	111,138
Additional paid-in capital	3,034	2,937
Retained earnings	158,650	144,197
Accumulated other comprehensive loss, net	(10,555)	(2,330)

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Total shareholders' equity	263,208	255,942
Total liabilities and shareholder's equity	\$2,463,040	\$2,340,298

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest and dividend income				
Loans and leases, including fees	\$22,824	\$16,543	\$64,332	\$47,349
Taxable securities	2,382	2,224	7,020	6,385
Tax-exempt securities	1,006	1,002	3,040	2,739
Federal funds sold and other	24	63	204	317
Total interest income	26,236	19,832	74,596	56,790
Interest expense				
Deposits	1,923	1,032	4,835	2,588
Short-term borrowings	86	14	152	34
Subordinated debentures	451	351	1,273	1,009
Total interest expense	2,460	1,397	6,260	3,631
Net interest income	23,776	18,435	68,336	53,159
Provision for loan losses	2,450	—	2,950	300
Net interest income after provision for loan losses	21,326	18,435	65,386	52,859
Non-interest income				
Service charges on deposits	3,208	2,916	9,181	8,263
Other income	2,515	2,994	7,104	8,145
Total non-interest income	5,723	5,910	16,285	16,408
Other operating expense				
Salaries and employee benefits	8,814	7,478	26,994	22,617
Occupancy and equipment	2,685	2,368	7,484	6,923
Other	6,308	5,599	18,510	16,698
Total other operating expense	17,807	15,445	52,988	46,238
Income before taxes	9,242	8,900	28,683	23,029
Provision for income taxes	2,171	3,158	6,910	7,533
Net income	\$7,071	\$5,742	\$21,773	\$15,496
PER SHARE DATA				
Book value	\$17.23	\$15.83	\$17.23	\$15.83
Cash dividends	\$0.16	\$0.14	\$0.48	\$0.42
Earnings per share basic	\$0.46	\$0.41	\$1.43	\$1.12
Earnings per share diluted	\$0.46	\$0.41	\$1.41	\$1.11
Average shares outstanding, basic	15,267,587	13,839,111	15,251,746	13,824,173
Average shares outstanding, diluted	15,444,406	14,013,987	15,428,465	14,010,894
Total shareholder equity (in thousands)	\$263,208	\$219,083	\$263,208	\$219,083
Shares outstanding	15,277,710	13,840,429	15,277,710	13,840,429
Dividends paid (in thousands)	\$2,442	\$1,937	\$7,320	\$5,805

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands, unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net income	\$7,071	\$5,742	\$21,773	\$15,496
Other comprehensive income, before tax:				
Unrealized (losses) gains on securities:				
Unrealized holding (loss) gain arising during period	(2,892)	(713)	(11,676)	5,065
Less: reclassification adjustment for gains included in net income ⁽¹⁾	(1)	(918)	(2)	(984)
Other comprehensive (loss) income, before tax	(2,893)	(1,631)	(11,678)	4,081
Income tax expense related to items of other comprehensive income (loss), net of tax	854	686	3,453	(1,716)
Other comprehensive (loss) income	(2,039)	(945)	(8,225)	2,365
Comprehensive income	\$5,032	\$4,797	\$13,548	\$17,861

⁽¹⁾ Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended September 30, 2018 and 2017 was \$0 and \$386 thousand respectively. Income tax expense associated with the reclassification adjustment for the nine months ended September 30, 2018 and 2017 was \$1 thousand and \$414 thousand respectively.

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Nine months ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$21,773	\$ 15,496
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of securities	(2)	(984)
Gain on sales of loans	—	(3)
Loss on disposal of fixed assets	13	66
Gain on sale on foreclosed assets	(733)	(12)
Writedowns on foreclosed assets	195	75
Share-based compensation expense	274	459
Provision for loan losses	2,950	300
Depreciation and amortization	2,365	2,177
Net amortization on securities premiums and discounts	4,269	5,083
Accretion of discounts for loans acquired and net deferred loan fees	(1,368)	(717)
Increase in cash surrender value of life insurance policies	(1,067)	(1,188)
Amortization of core deposit intangible	752	320
Decrease (increase) in interest receivable and other assets	251	(5,071)
Increase in other liabilities	(4,897)	(12)
Deferred income tax benefit	(956)	(336)
Net amortization of partnership investment	1,242	1,943
Net cash provided by operating activities	25,061	17,596
Cash flows from investing activities:		
Maturities of securities available for sale	3,534	1,165
Proceeds from sales/calls of securities available for sale	9,913	22,325
Purchases of securities available for sale	(90,879)	(151,711)
Principal pay downs on securities available for sale	71,002	75,086
Net purchases of FHLB stock	(301)	(235)
Loan originations and payments, net	(137,860)	(49,983)
Purchases of premises and equipment, net	(2,854)	(1,589)
Proceeds from sales of foreclosed assets	3,987	99
Purchase of company owned life insurance	(384)	(376)
Increase in partnership investment	—	(5,000)
Net cash from bank acquisition	(6)	—
Net cash used in investing activities	(143,848)	(110,219)
Cash flows from financing activities:		
Increase in deposits	117,667	84,108
Decrease in borrowed funds	(5,800)	(54,500)
Increase in Fed funds purchased	—	1,600

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Increase in repurchase agreements	8,372	585
Cash dividends paid	(7,320)	(5,804)
Stock options exercised	770	799
Net cash provided by financing activities	113,689	26,788
Decrease in cash and due from banks	(5,098)	(65,835)
Cash and cash equivalents		
Beginning of period	70,137	120,442
End of period	\$65,039	\$54,607

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

Sierra Bancorp

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2018

(Unaudited)

Note 1 – The Business of Sierra Bancorp

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

Bank of the Sierra, a California state-chartered bank headquartered in Porterville, California, offers a full range of retail and commercial banking services via branch offices located throughout California’s South San Joaquin Valley, the Central Coast, Ventura County, and neighboring communities. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with \$1.5 million in capital. Our growth in the ensuing years has largely been organic in nature, but includes four whole-bank acquisitions: Sierra National Bank in 2000, Santa Clara Valley Bank in 2014, Coast National Bank in 2016, and Ojai Community Bank in October 2017. Details on our most recent acquisitions are provided in Note 14 to the consolidated financial statements. We also acquired a branch located in Lompoc, California from Community Bank of Santa Maria in May 2018, and opened a new branch on Palm Avenue in Fresno in September 2018. As of the filing date of this report the Bank operates 40 full service branches and an online branch, and maintains ATMs at all branch locations and seven non-branch locations. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. The Company had total assets of close to \$2.5 billion at September 30, 2018, and for a number of years we have claimed the distinction of being the largest bank headquartered in the South San Joaquin Valley. The Bank’s deposit accounts, which totaled \$2.1 billion at September 30, 2018, are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to maximum insurable amounts.

Note 2 – Basis of Presentation

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

December 31, 2017, as filed with the Securities and Exchange Commission (the "SEC").

Note 3 – Current Accounting Developments

In May 2014 the FASB issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is the result of a joint project initiated by the FASB and the International Accounting Standards Board ("IASB") to clarify the principles for recognizing revenue, and to develop common revenue standards and disclosure requirements that would: (1) remove inconsistencies and weaknesses in revenue requirements; (2) provide a more robust framework for addressing revenue issues; (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; (4) provide more useful information to users of financial statements through improved disclosures; and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that

reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required with regard to contracts with customers, as well as for significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The guidance does not apply to revenue associated with financial instruments such as loans and investments, which is accounted for under other provisions of GAAP. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein, and the Company thus adopted ASU 2014-09 on January 1, 2018 utilizing the modified retrospective approach. The Company's primary source of revenue is derived from income on financial instruments, which is not impacted by the guidance in ASU 2014-09. Furthermore, the Company evaluated the nature of its non-interest income, and determined that for income associated with customer contracts transaction prices are typically fixed and performance obligations are satisfied as services are rendered. Therefore, there is little or no judgment involved in the timing of revenue recognition under contracts within the scope of ASU 2014-09, and there was no impact on our financial statements upon the adoption of ASU 2014-09. Please see Note 13 to the consolidated financial statements for more detailed disclosure information.

In January 2016 the FASB issued ASU 2016-01, Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. This guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Among other things, the guidance in this ASU (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or in the accompanying notes to the financial statements, and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. This amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities are required to apply the amendment by means of a cumulative-effect adjustment as of the beginning of the fiscal year of adoption, except for the amendment related to equity securities without readily determinable fair values which should be applied prospectively to equity investments that exist as of the date of adoption. The Company adopted ASU 2016-01 effective January 1, 2018, and it did not have a material impact on the Company's consolidated financial statements. In accordance with (iv) above, the Company measured the fair value of its loan portfolio at September 30, 2018 using an exit price notion. See Note 9 Fair Value Disclosures and Reporting, the Fair Value Option and Fair Value Measurements.

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

corresponding lease liabilities subsequent to implementing ASU 2016-02, but we are still evaluating the extent to which this will impact our consolidated financial statements.

In March 2016 the FASB issued ASU 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, as part of its simplification initiative. ASU 2016-09 became effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. Accordingly, the Company adopted ASU 2016-09 effective January 1, 2017. Prior guidance dictated that as they relate to share-based payments, tax benefits in excess of compensation costs (“windfalls”) were to be recorded in equity, and tax deficiencies (“shortfalls”) were to be recorded in equity to the extent of previous windfalls and then to the income statement. ASU 2016-09 reduced some of the administrative complexities by eliminating the need to track a windfall “pool,” but it increases the volatility of income tax expense. ASU 2016-09 also removed the requirement to delay recognition of a windfall tax benefit until such time as it reduces current taxes payable. Under this guidance, the benefit is recorded when it arises, subject to normal valuation allowance considerations. This

change was applied by us on a modified retrospective basis, as required, with a cumulative-effect adjustment to opening retained earnings. Furthermore, all tax-related cash flows resulting from share-based payments are now reported as operating activities on the statement of cash flows, a change from the previous requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. However, cash paid by an employer when directly withholding shares for tax withholding purposes is classified as a financing activity. Pursuant to the guidance, entities were permitted to make an accounting policy election for the impact of forfeitures on expense recognition for share-based payment awards. Forfeitures can be estimated in advance, as required previously, or recognized as they occur. Estimates are still required in certain circumstances, such as when an award is modified or a replacement award is issued in a business combination. If elected, the change to recognize forfeitures when they occur would have been adopted using a modified retrospective approach, with a cumulative effect adjustment recorded to opening retained earnings. We did not elect to recognize forfeitures as they occur, and continue to estimate potential forfeitures in advance.

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

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

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

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

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

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

In February 2018 the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments–Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This new guidance relates to ASU 2016-01, which provides for a measurement alternative for certain equity investments that do not have readily determinable fair values. ASU 2018-03 allows a company to change its measurement approach for such equity investments to the “fair value through

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

In August 2018 the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement, as part of its disclosure framework project. Pursuant to this guidance, disclosures that will no longer be required include the following: transfers between Level 1 and Level 2 of the fair value hierarchy; transfers in and out of Level 3 for nonpublic entities, as well as purchases and issuances and the Level 3 roll forward; a company’s policy for determining when transfers between any of the three levels have occurred; the valuation processes used for Level 3 measurements; and, the changes in unrealized gains or losses presented in earnings for Level 3 instruments held at the balance sheet date for nonpublic entities. The following are additional disclosure requirements: for public entities, the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 instruments held at the balance sheet date; for public entities, the range and weighted average of significant unobservable inputs used for Level 3 measurements, although for certain unobservable inputs the entity will be allowed to disclose other quantitative information in place of the weighted average to the extent that it would be a more reasonable and rational method to reflect the distribution of unobservable inputs; for nonpublic entities, some form of quantitative information about significant unobservable inputs used in Level 3 fair value measurements; and, for certain investments in entities that calculate the net asset value, disclosures will be required about the timing of liquidation and redemption restrictions lapsing if the latter has been communicated to the reporting entity. The guidance also clarifies that the Level 3 measurement uncertainty disclosure should communicate information about the uncertainty at the balance sheet date. ASU 2018-13 is effective for all entities in fiscal years beginning after December 15, 2019, including interim periods. Early adoption is permitted. In addition, an entity may early adopt any of the removed or modified disclosures immediately and delay adoption of the new disclosures until the effective date.

Note 4 – Supplemental Disclosure of Cash Flow Information

During the nine months ended September 30, 2018 and 2017, cash paid for interest due on interest-bearing liabilities was \$5.880 million and \$3.645 million, respectively. There was \$10.000 million in cash paid for income taxes during the nine months ended September 30, 2018, and \$6.497 million during the nine months ended September 30,

2017. There were assets totaling \$180,000 that were acquired in settlement of loans for the nine months ended September 30, 2018, relative to \$648,000 during the nine months ended September 30, 2017. We received \$3.987 million in cash from the sale of foreclosed assets during the first nine months of 2018 relative to \$99,000 during the first nine months of 2017, which represents sales proceeds less loans (if any) extended to finance such sales.

Note 5 – Share Based Compensation

On March 16, 2017 the Company’s Board of Directors approved and adopted the 2017 Stock Incentive Plan (the “2017 Plan”), which became effective May 24, 2017, the date approved by the Company’s shareholders. The 2017 Plan replaced the Company’s 2007 Stock Incentive Plan (the “2007 Plan”), which expired by its own terms on March 15, 2017. Options to purchase 392,770 shares that were granted under the 2007 Plan were still outstanding as of September 30, 2018 and remain unaffected by that plan’s expiration. The 2017 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of

“nonqualified” stock options to non-employee directors and consultants of the Company. The 2017 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, although no restricted stock awards have ever been issued by the Company. The total number of shares of the Company’s authorized but unissued stock reserved for issuance pursuant to awards under the 2017 Plan was initially 850,000 shares, and the number remaining available for grant as of September 30, 2018 was 767,000. The potential dilutive impact of unexercised stock options is discussed below in Note 6, Earnings per Share.

Pursuant to FASB’s standards on stock compensation, the value of each stock option granted is reflected in our income statement as employee compensation or directors’ expense by expensing its fair value as of the grant date in the case of immediately vested options, or by amortizing its grant date fair value over the vesting period for options with graded vesting. The Company is utilizing the Black-Scholes model to value stock options, and the “multiple option” approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee’s options for each vesting period are separately valued and amortized. A pre-tax charge of \$101,000 was reflected in the Company’s income statement during the third quarter of 2018 and \$18,000 was charged during the third quarter of 2017, as expense related to stock options. For the first nine months, the charges totaled \$274,000 in 2018 and \$459,000 in 2017.

Note 6 – Earnings per Share

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 15,267,587 weighted average shares outstanding during the third quarter of 2018, and 13,839,111 during the third quarter of 2017. There were 15,251,746 weighted average shares outstanding during the first nine months of 2018, and 13,824,173 during the first nine months of 2017.

Diluted earnings per share calculations include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of “in-the-money” stock options. For the third quarter of 2018, calculations under the treasury stock method resulted in the equivalent of 176,819 shares being added to basic weighted average shares outstanding for purposes of determining diluted earnings per share, while a weighted average of 105,800 stock options were excluded from the calculation because they were underwater and thus anti-dilutive. For the third quarter of 2017 the equivalent of 174,876 shares were added in calculating diluted earnings per share, while 120,700 anti-dilutive stock options were not factored into the computation. Likewise, for the first nine months of 2018 the equivalent of 176,719 shares were added to basic weighted average shares outstanding in calculating diluted earnings per share and a weighted average of 105,800 stock options that were anti-dilutive for the period were not included, compared to the addition of the equivalent of 186,721 shares and non-inclusion of 120,700 anti-dilutive options in calculating diluted earnings per share for first nine months of 2017.

Note 7 – Comprehensive Income

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

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

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

	September	December
	30, 2018	31, 2017
Commitments to extend credit	\$ 771,989	\$ 691,712
Standby letters of credit	\$ 10,378	\$ 9,168

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

At September 30, 2018, the Company was also utilizing a letter of credit in the amount of \$95 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

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

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

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

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

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

with precision. Changes in assumptions could significantly alter the fair values presented.

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

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

	September 30, 2018				
	Fair Value Measurements				
	Quoted Prices in				
	Significant		Significant		
	Active Markets for				
	Observable		Unobservable		
	Identical				
Carrying	Assets	Inputs	Inputs	Inputs	
Amount	(Level 1)	(Level 2)	(Level 3)	Total	
Financial assets:					
Cash and cash equivalents	\$65,039	\$65,039	\$—	\$—	\$65,039
Investment securities available for sale	548,815	—	548,815	—	548,815
Loans and leases, net held for investment	1,679,413	—	1,659,164	—	1,659,164
Collateral dependent impaired loans	8,236	—	8,196	—	8,196
Financial liabilities:					
Deposits	2,106,053	797,362	1,308,247	—	2,105,609
Repurchase agreements	16,522	16,522	—	—	16,522
Subordinated debentures	34,722	—	29,080	—	29,080
	December 31, 2017				
	Fair Value Measurements				
	Quoted Prices in				
	Significant		Significant		
	Active Markets for				
	Observable		Unobservable		
	Identical				
Carrying	Assets	Inputs	Inputs	Inputs	
Amount	(Level 1)	(Level 2)	(Level 3)	Total	
Financial assets:					
Cash and cash equivalents	\$70,137	\$70,141	\$—	\$—	\$70,141
Investment securities available for sale	558,329	—	558,329	—	558,329
Loans and leases, net held for investment	1,551,174	—	1,563,765	—	1,563,765
Collateral dependent impaired loans	377	—	377	—	377
Financial liabilities:					
Deposits	1,988,386	750,458	1,237,716	—	1,988,174
Repurchase agreements	8,150	8,150	—	—	8,150
Subordinated debentures	34,588	—	24,216	—	24,216

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

Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.

Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

Foreclosed assets: Repossessed real estate (known as other real estate owned, or "OREO") and other foreclosed assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes; fair values for any other foreclosed assets are represented by estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as

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necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

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

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

	Fair Value Measurements at September 30, 2018, using Quoted Prices in Significant Active Markets for Identical Assets				Realized Gain/(Loss) (Level 3)
	Observable Inputs (Level 1)	Unobservable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total	
Securities:					
US Government agencies	\$—	\$ 16,043	\$ —	\$ 16,043	\$ —
Mortgage-backed securities	—	396,690	—	396,690	—
State and political subdivisions	—	136,082	—	136,082	—
Total available-for-sale securities	\$—	\$ 548,815	\$ —	\$ 548,815	\$ —

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

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

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

Fair Value Measurements at September 30,
 2018, using
 Quoted Prices in
 Active Markets for

	Identifiable Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real estate:				
1-4 family residential construction	\$ —	\$ —		