AMERICAN RIVER BANKSHARES
Form 10-Q
August 06, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

or

o 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: 0-31525

AMERICAN RIVER BANKSHARES
(Exact name of registrant as specified in its charter)

California	68-0352144
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3100 Zinfandel Drive, Suite 450, Rancho Cordova, California	95670
(Address of principal executive offices)	(Zip Code)

(916) 851-0123
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report.)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

No par value Common Stock – 8,833,562 shares outstanding at August 6, 2013.

AMERICAN RIVER BANKSHARES

INDEX TO QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2013

PART I-FINANCIAL INFORMATION

Item 1. Financial Statements.
AMERICAN RIVER BANKSHARES
CONSOLIDATED BALANCE SHEET
(Unaudited)

(dollars in thousands)	June 30, 2013	December 31, 2012
ASSETS		
Cash and due from banks	$ 23,694	$ 55,461
Interest-bearing deposits in banks	1,000	750
Investment securities:		
Available-for-sale, at fair value	254,644	231,839
Held-to-maturity, at amortized cost	1,497	2,117
Loans and leases, less allowance for loan and lease losses of $5,680 at June 30, 2013 and $5,781 at December 31, 2012	247,778	252,118
Premises and equipment, net	1,673	1,888
Federal Home Loan Bank stock	3,248	3,254
Goodwill and other intangible assets	16,321	16,321
Other real estate owned	8,120	12,237
Bank owned life insurance	12,562	12,858
Accrued interest receivable and other assets	7,008	7,546
	$ 577,545	$ 596,389
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest bearing	$ 138,463	$ 151,201
Interest-bearing	329,194	327,055
Total deposits	467,657	478,256
Short-term borrowings	8,000	2,000
Long-term borrowings	8,000	16,000
Accrued interest payable and other liabilities	5,434	6,139

Total liabilities		489,091		502,395
Commitments and contingencies				
Shareholders' equity:				
Preferred stock, no par value; 20,000,000 shares authorized; none outstanding				
Common stock, no par value; 20,000,000 shares authorized; issued and outstanding – 8,833,562 shares at June 30, 2013 and 9,327,203 shares at December 31, 2012		64,134		67,977
Retained earnings		23,006		21,732
Accumulated other comprehensive income, net of taxes		1,314		4,285
Total shareholders' equity		88,454		93,994
	$	577,545	$	596,389

See Notes to Unaudited Consolidated Financial Statements

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AMERICAN RIVER BANKSHARES
CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

(dollars in thousands, except per share data)				
For the periods ended June 30,	Three months		Six months	
	2013	2012	2013	2012
Interest income:				
Interest and fees on loans	$3,516	$4,238	$7,158	$8,554
Interest on deposits in banks	—	3	1	6
Interest and dividends on investment securities:				
Taxable	805	931	1,593	1,821
Exempt from Federal income taxes	221	148	441	449
Dividends	9	4	9	4
Total interest income	4,551	5,324	9,202	10,834
Interest expense:				
Interest on deposits	301	418	632	853
Interest on borrowings	74	64	150	131
Total interest expense	375	482	782	984
Net interest income	4,176	4,842	8,420	9,850
Provision for loan and lease losses	100	375	200	955
Net interest income after provision for loan and lease losses	4,076	4,467	8,220	8,895
Noninterest income:				
Service charges on deposit accounts	147	194	298	390
Gain on sale of securities	3	11	3	75
Other noninterest income	298	489	772	922
Total noninterest income	448	694	1,073	1,387
Noninterest expense:				
Salaries and employee benefits	2,175	2,033	4,393	4,235
Occupancy	301	299	602	595
Furniture and equipment	191	202	385	392
Federal Deposit Insurance Corporation assessments	(16)	141	110	283
Expenses related to other real estate owned	195	468	500	842
Other expense	766	908	1,624	1,816
Total noninterest expense	3,612	4,051	7,614	8,163
Income before provision for income taxes	912	1,110	1,679	2,119
Provision for income taxes	260	265	405	562
Net income	$652	$845	$1,274	$1,557
Basic earnings per share	$0.07	$0.09	$0.14	$0.16

Diluted earnings per share	$0.07	$0.09	$0.14	$0.16
Cash dividends per share	$0.00	$0.00	$0.00	$0.00

See notes to Unaudited Consolidated Financial Statements

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AMERICAN RIVER BANKSHARES
CONSOLIDATED STATEMENT OF COMPRENENSIVE (LOSS) INCOME
(Unaudited)

(dollars in thousands, except per share data)

For the periods ended June 30,	Three months		Six months	
	2013	2012	2013	2012
Net income	$652	$845	$1,274	$1,557
Other comprehensive (loss) income:				
Unrealized holding (losses) gains on investment securities arising during the period	(4,517)	761	(4,949)	1,380
Deferred tax expense	1,807	(302)	1,980	(534)
Unrealized holding (losses) gains on investment securities arising during the period, net of tax	(2,710)	459	(2,969)	846
Reclassification adjustment for realized gains included in net income	(3)	(11)	(3)	(75)
Tax effect	1	5	1	30
Realized gains, net of tax	(2)	(6)	(2)	(45)
Total other comprehensive (loss) income	(2,712)	453	(2,971)	801
Comprehensive (loss) income	$(2,060)	$1,298	$(1,697)	$2,358

See Notes to Unaudited Consolidated Financial Statements

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AMERICAN RIVER BANKSHARES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

(dollars in thousands)	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, January 1, 2012	9,890,909	72,016	18,525	3,558	94,099
Net income			3,207		3,207
Other comprehensive income, net of tax:					
Net change in unrealized gains on available-for-sale investment securities				727	727
Net restricted stock awarded and related compensation expense	11,683	110			110
Stock option compensation expense		45			45
Retirement of common stock	(575,389)	(4,194)			(4,194)
Balance, December 31, 2012	9,327,203	67,977	21,732	4,285	93,994
Net income			1,274		1,274
Other comprehensive loss, net of tax:					
Net change in unrealized gains on available-for-sale investment securities				(2,971)	(2,971)
Net restricted stock award activity and related compensation expense	11,448	50			50
Stock option compensation expense		13			13
Retirement of common stock	(505,089)	(3,906)			(3,906)
Balance, June 30, 2013	8,833,562	$64,134	$23,006	$ 1,314	$ 88,454

See Notes to Unaudited Consolidated Financial Statements

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AMERICAN RIVER BANKSHARES
CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

(dollars in thousands) For the six months ended June 30,	2013	2012
Cash flows from operating activities:		
Net income	$1,274	$1,557
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	200	955
Increase (decrease) in deferred loan origination fees, net	16	(70)
Depreciation and amortization	266	816
Gain on sale and call of investment securities	(3)	(75)
Amortization of investment security premiums and discounts, net	2,915	2,060
Gain on life insurance death benefit	(118)	—
Increase in cash surrender values of life insurance policies	(5)	(132)
Stock based compensation expense	63	79
Loss on sale and write-down of other real estate owned	208	373
Decrease in accrued interest receivable and other assets	2,518	403
(Decrease) increase in accrued interest payable and other liabilities	(705)	1,642
Net cash provided by operating activities	6,629	7,608
Cash flows from investing activities:		
Proceeds from the sale of available-for-sale investment securities	5,822	5,543
Proceeds from matured available-for-sale investment securities	185	665
Proceeds from called available-for-sale investment securities	—	195
Purchases of available-for-sale investment securities	(68,408)	(43,475)
Proceeds from principal repayments for available-for-sale investment securities	31,731	23,284
Proceeds from principal repayments for held-to-maturity investment securities	621	964
Net (increase) decrease in interest-bearing deposits in banks	(250)	250
Net decrease in loans	3,692	11,886
Proceeds from sale of other real estate	4,529	807
Capitalized additions to other real estate	(187)	—
Death benefit from life insurance policy	419	—
Net decrease (increase) in FHLB stock	6	(161)
Purchases of equipment	(51)	(152)
Net cash used in investing activities	(21,891)	(194)
Cash flows from financing activities:		
Net (decrease) increase in demand, interest-bearing and savings deposits	$(10,067)	$9,032
Net (decrease) increase in time deposits	(532)	4,237
Net increase (decrease) in short-term borrowings	6,000	(3,000)
Net decrease in long-term borrowings	(8,000)	(2,000)
Cash paid to repurchase common stock	(3,906)	(4,194)

Net cash (used in) provided by financing activities	$(16,505)	$4,075
(Decrease) increase in cash and cash equivalents	(31,767)	11,489
Cash and cash equivalents at beginning of year	55,461	23,768
Cash and cash equivalents at end of period	$23,694	$35,257

See Notes to Unaudited Consolidated Financial Statements

AMERICAN RIVER BANKSHARES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2013

1. CONSOLIDATED FINANCIAL STATEMENTS

In the opinion of management, the unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the consolidated financial position of American River Bankshares (the “Company”) at June 30, 2013 and December 31, 2012, the results of its operations and statement of comprehensive income for the three and six month periods ended June 30, 2013 and 2012, its cash flows for the six-month periods ended June 30, 2013 and 2012 and its statement of changes in shareholders’ equity for the year ended December 31, 2012 and the six months ended June 30, 2013 in conformity with accounting principles generally accepted in the United States of America.

Certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s 2012 annual report on Form 10-K. The results of operations for the three-month and six-month periods ended June 30, 2013 may not necessarily be indicative of the operating results for the full year.

In preparing such financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant changes in the near term relate to the determination of the allowance for loan and lease losses, the provision for taxes, the valuation of goodwill and the estimated fair value of investment securities, impaired loans and other real estate owned.

Management has determined that since all of the banking products and services offered by the Company are available in each branch office of American River Bank, all branch offices are located within the same economic environment and management does not allocate resources based on the performance of different lending or transaction activities, it is appropriate to aggregate all of the branch offices and report them as a single operating segment. No client accounts for more than ten percent (10%) of revenues for the Company or American River Bank.

2. STOCK-BASED COMPENSATION

Equity Plans

On March 17, 2010, the Board of Directors adopted the 2010 Equity Incentive Plan (the “2010 Plan”). The 2010 Plan was approved by the Company’s shareholders on May 20, 2010. In 2000, the Board of Directors adopted and the Company’s shareholders approved a stock option plan (the “2000 Plan”), under which 261,521 options remain outstanding at June 30, 2013. At June 30, 2013, there were 17,329 stock options and 27,259 restricted shares outstanding and the total number of authorized shares that remain available for issuance under the 2010 Plan was 1,435,581. The 2010 Plan provides for the following types of stock-based awards: incentive stock options; nonqualified stock options; stock appreciation rights; restricted stock; restricted performance stock; unrestricted Company stock; and performance units. Awards granted under the 2000 Plan were either incentive stock options or nonqualified stock options. Under the 2010 Plan, the awards may be granted to employees and directors under incentive and nonstatutory agreements and other awards agreements. The 2010 Plan and the 2000 Plan (collectively the “Plans”) require that the option price may not be less than the fair market value of the stock at the date the option is granted. The option awards under the Plans expire on dates determined by the Board of Directors, but not later than ten years from the date of award. The vesting period is generally five years; however, the vesting period can be modified at the discretion of the Company's Board of Directors. Outstanding option awards under the Plans are exercisable until their expiration, however, no new options will be awarded under the 2000 Plan. New shares are issued upon exercise of an option.

The grant date fair value of awards is determined by the market price of the Company's common stock on the date of grant and is recognized ratably as compensation expense or director expense over the vesting periods. The shares of common stock granted pursuant to such agreements vest in increments over one to five years from the date of grant. The shares awarded to employees and directors under the restricted stock agreements vest on the applicable vesting dates only to the extent the recipient of the shares is then an employee or a director of the Company or one of its subsidiaries, and each recipient will forfeit all of the shares that have not vested on the date his or her employment or service is terminated.

Equity Compensation

For the three-month periods ended June 30, 2013 and 2012, the compensation cost recognized for equity compensation was $36,000 and $46,000, respectively. The recognized tax benefit for equity compensation expense was $14,000 for the three-month periods ended June 30, 2013 and 2012, respectively. For the six-month periods ended June 30, 2013 and 2012, the compensation cost recognized for equity compensation was $69,000 and $79,000, respectively. The recognized tax benefit for equity compensation expense was $22,000 for the six-month periods ended June 30, 2013 and 2012, respectively.

At June 30, 2013, the total compensation cost related to nonvested stock option awards not yet recorded was $39,000. This amount will be recognized over the next 4.0 years and the weighted average period of recognizing these costs is expected to be 1.6 years. At June 30, 2013, the total compensation cost related to restricted stock awards not yet recorded was $195,000. This amount will be recognized over the next 4.0 years and the weighted average period of recognizing these costs is expected to be 1.3 years.

Equity Plans Activity

Stock Options

There were no stock options awarded during the three and six-month periods ended June 30, 2013. There were 17,329 stock options awarded during the three and six-month periods ended June 30, 2012 at an average exercise price of $7.07. The weighted average grant date fair value of options granted for the three and six- month periods ended June 30, 2012 was $2.31. A summary of option activity under the Plans as of June 30, 2013 and changes during the period then ended is presented below:

Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 2013	305,670	$ 16.71	4.0 years	$ —
Granted	—	—	—	—
Exercised	—	—	—	—
Cancelled	26,820	11.68	—	—
Outstanding at June 30, 2013	278,850	$ 17.20	3.6 years	$ 20
Vested at June 30, 2013	256,299	$ 18.04	3.2 years	$ 4
Non-vested at June 30, 2013	22,551	$ 7.63	7.6 years	$ 16

Restricted Stock

There were 11,448 shares of restricted stock awarded during the three- and six-month periods ended June 30, 2013. The 11,448 restricted common shares will vest one year from the date of the award. There were 16,207 shares of restricted stock awarded during the three- and six-month periods ended June 30, 2012. Of the 16,207 restricted common shares, 9,898 vested one year from the date of the award and 6,309 will vest over five years at 20% per year from the date of the award. Grant date fair value is determined by the market price of the Company’s common stock on the date of grant ($7.86 on May 16, 2013 and $7.07 on May 16, 2012).

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There were 11,158 restricted awards that were fully vested during the three and six-month periods ended June 30, 2013 and zero restricted awards that were fully vested during the three and six-month periods ended June 30, 2012. There were zero awards that had been forfeited during the three and six-month periods ended June 30, 2013 and zero and 3,246 awards that had been forfeited during the three and six-month periods ended June 30, 2012. The intrinsic value of nonvested restricted stock at June 30, 2013 was $224,000.

Restricted Stock	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2013	26,969	$ 6.79
Awarded	11,448	7.86
Less: Vested	11,158	7.07
Less: Cancelled	—	—
Nonvested at June 30, 2013	27,259	$ 7.12

Other Equity Awards

There were no stock appreciation rights; restricted performance stock; unrestricted Company stock; or performance units awarded during the three or six month periods ended June 30, 2013 or 2012.

The intrinsic value used for stock options and restricted stock was derived from the market price of the Company's common stock of $8.22 as of June 30, 2013.

3. COMMITMENTS AND CONTINGENCIES

In the normal course of business there are outstanding various commitments to extend credit which are not reflected in the financial statements, including loan commitments of approximately $25,328,000 and standby letters of credit of approximately $6,149,000 at June 30, 2013 and loan commitments of approximately $26,518,000 and standby letters of credit of approximately $6,506,000 at December 31, 2012. Such commitments relate primarily to real estate construction loans, revolving lines of credit and other commercial loans. However, all such commitments will not necessarily culminate in actual extensions of credit by the Company during 2013 as some of these are expected to expire without being fully drawn upon.

Standby letters of credit are commitments issued to guarantee the performance or financial obligation of a client to a third party. These guarantees are issued primarily relating to purchases of inventory, insurance programs, performance obligations to government agencies, or as security for real estate rents by commercial clients and are typically short-term in nature. Credit risk is similar to that involved in extending loan commitments to clients and accordingly, evaluation and collateral requirements similar to those for loan commitments are used. The majority of all such commitments are collateralized. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at June 30, 2013 or December 31, 2012.

4. EARNINGS PER SHARE COMPUTATION

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding for the period (8,893,367 and 9,050,669 shares for the three-month and six-month periods ended June 30, 2013, and 9,518,897 and 9,671,083 for the three-month and six-month periods ended June 30, 2012). Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options or restricted stock, result in the issuance of common stock. Diluted earnings per share is computed by dividing net income by the weighted average common shares outstanding for the period plus the dilutive effect of stock based awards. There were 4,758 and 3,983, respectively, dilutive shares for the three-month and six-month periods ended

June 30, 2013 and 13,306 and 11,794, respectively, dilutive shares for the three-month and six-month periods ended June 30, 2012. Earnings per share is retroactively adjusted for stock dividends and stock splits, if applicable, for all periods presented.

5. INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities at June 30, 2013 and December 31, 2012 consisted of the following (dollars in thousands):

Available-for-Sale

	June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
Mortgage-backed securities	$222,822	$ 3,467	$ (2,141)	$224,148
Obligations of states and political subdivisions	28,062	910	(151)	28,821
Corporate bonds	1,506	70	—	1,576
Equity securities:				
Corporate stock	64	35	—	99
	$252,454	$ 4,482	$ (2,292)	$254,644

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
Mortgage-backed securities	$195,444	$ 5,661	$ (590)	$200,515
Obligations of states and political subdivisions	27,682	1,974	—	29,656
Corporate bonds	1,507	87	—	1,594
Equity securities:				
Corporate stock	64	10	—	74
	$224,697	$ 7,732	$ (590)	$231,839

Net unrealized gains on available-for-sale investment securities totaling $2,190,000 were recorded, net of $876,000 in tax liabilities, as accumulated other comprehensive income within shareholders' equity at June 30, 2013. Proceeds and gross realized gains from the sale and call of available-for-sale investment securities for the three-month period ended June 30, 2013 totaled zero and zero, respectively, and for the six-month period ended June 30, 2013 totaled $5,822,000 and $3,000, respectively. There were no transfers of available-for-sale investment securities for the three- and six-month periods ended June 30, 2013.

Net unrealized gains on available-for-sale investment securities totaling $4,285,000 were recorded, net of $2,857,000 in tax liabilities, as accumulated other comprehensive income within shareholders' equity at December 31, 2012. Proceeds and gross realized gains from the sale and call of available-for-sale investment securities for the three-month period ended June 30, 2012 totaled $830,000 and $11,000, respectively, and for the six-month period ended June 30, 2012 totaled $5,738,000 and $75,000, respectively. There were no transfers of available-for-sale investment securities for the three- and six-month periods ended June 30, 2012.

Held-to-Maturity

June 30, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
Mortgage-backed securities	$ 1,497	$ 89	$ —	$ 1,586

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December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
Mortgage-backed securities	$ 2,117	$ 138	$ —	$ 2,255

There were no sales or transfers of held-to-maturity investment securities for the periods ended June 30, 2013 and June 30, 2012. Investment securities with unrealized losses at June 30, 2013 and December 31, 2012 are summarized and classified according to the duration of the loss period as follows (dollars in thousands):

2013	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-Sale						
Debt securities:						
Mortgage-backed securities	$83,494	$ (2,141)	—	—	$83,494	$ (2,141)
Obligations of states and political subdivisions	4,282	(151)	—	—	4,282	(151)
	$87,776	$ (2,292)	$ —	$ —	$87,776	$ (2,292)

2012	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-Sale						
Debt securities:						
Mortgage-backed securities	$37,440	$ (590)	—	—	$37,440	$ (590)
	$37,440	$ (590)	$ —	$ —	$27,440	$ (590)

There were no held-to-maturity investment securities with unrealized losses as of June 30, 2013 or December 31, 2012.

At June 30, 2013, the Company held 216 securities of which 40 were in a loss position for less than twelve months and none were in a loss position for twelve months or more. Of the 40 securities in a loss position, 35 are mortgage-backed securities and five are obligations of states and political subdivisions. At December 31, 2012, the Company held 196 securities of which 16 were in a loss position for less than twelve months and none were in a loss position for twelve months or more. All 16 securities in a loss position were mortgage-backed securities.

The unrealized loss on the Company’s investments in mortgage-backed securities, obligations of states and political subdivisions, and corporate bonds, is primarily driven by interest rates. Because the decline in market value is attributable to a change in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until recovery of fair value, which may be until maturity, management does not consider these investments to be other-than-temporarily impaired.

The amortized cost and estimated fair values of investment securities at June 30, 2013 by contractual maturity are shown below (dollars in thousands).

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Within one year	$825	$828		
After one year through five years	3,384	3,512		
After five years through ten years	11,618	12,066		
After ten years	13,741	13,991		
	29,568	30,397		
Investment securities not due at a single maturity date:				
Mortgage-backed securities	222,822	224,148	$1,497	$ 1,586
Corporate stock	64	99	—	—
	$252,454	$254,644	$1,497	$ 1,586

Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

6. IMPAIRED AND NONPERFORMING LOANS AND LEASES AND OTHER REAL ESTATE OWNED

At June 30, 2013 and December 31, 2012, the recorded investment in nonperforming loans and leases was approximately $5,364,000 and $5,474,000, respectively. Nonperforming loans and leases include all such loans and leases that are either placed on nonaccrual status or are 90 days past due as to principal or interest but still accrue interest because such loans are well-secured and in the process of collection. The Company considers a loan to be impaired when, based on current information and events, it is probable that it will be unable to collect all amounts due (principal and interest) according to the contractual terms of the original loan agreement. At June 30, 2013, the recorded investment in loans and leases that were considered to be impaired totaled $20,603,000, which includes $5,288,000 in nonaccrual loans and leases and $15,315,000 in performing loans and leases. Of the total impaired loans of $20,603,000, loans totaling $9,259,000 were deemed to require no specific reserve and loans totaling $11,344,000 were deemed to require a related valuation allowance of $1,495,000. At December 31, 2012, the recorded investment in loans and leases that were considered to be impaired totaled $26,553,000 and had a related valuation allowance of $1,595,000. If interest had been accruing on the nonperforming loans, such income would have approximated $109,000 and $200,000 for the three months ended June 30, 2013 and 2012, respectively, and approximated $168,000 and $472,000 for the six months ended June 30, 2013 and 2012, respectively.

At June 30, 2013 and December 31, 2012, the recorded investment in other real estate owned (“OREO”) was $8,120,000 and $12,237,000, respectively. For the three months ended March 31, 2013, the Company sold six properties with balances of $3,743,000 for a loss of $93,000 and added a single property to OREO with a net book value totaling $432,000. The single property is improved land with a long-term lease for a self-storage facility in Sonoma County. For the three months ended June 30, 2013, the Company sold one property with a balance of $805,000 for a gain of $22,000 and did not add any new OREO property.

The Company periodically obtains property valuations to determine whether the recorded book value is considered fair value. During the second quarter of 2013, this valuation process resulted in the Company reducing the book value of four properties by $137,000 all of which was charged to OREO expense.

The June 30, 2013 OREO balance of $8,120,000 consists of fourteen properties including four commercial real estate properties in the total amount of $3,265,000, six residential land properties in the total amount of $3,896,000, two commercial land properties in the total amount of $689,000 and two residential real estate properties in the total amount of $270,000.

Nonperforming loans and leases and OREO at June 30, 2013 and December 31, 2012 are summarized as follows:

(in thousands)	June 30, 2013		December 31, 2012	
Nonaccrual loans and leases that are current to terms (less than 30 days past due)	$ 1,183		$ 1,514	
Nonaccrual loans and leases that are past due	4,181		3,960	
Loans and leases past due 90 days and accruing interest	—		—	
Other real estate owned	8,120		12,237	
Total nonperforming assets	$ 13,484		$ 17,111	
Nonperforming loans and leases to total loans and leases	2.12	%	2.12	%
Total nonperforming assets to total assets	2.33	%	2.97	%

Impaired loans and leases as of and for the periods ended June 30, 2013 and December 31, 2012 are summarized as follows:

(in thousands)	As of June 30, 2013			As of December 31, 2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial	$670	$690	$ —	$1,248	$1,407	$ —
Real estate-commercial	8,297	9,082	—	10,882	11,603	—
Real estate-construction	256	256	—	263	263	—
Consumer	36	109	—	37	109	—
Subtotal	$9,259	$10,137	$ —	$12,430	$13,382	$ —
With an allowance recorded:						
Commercial	$1,588	$1,588	$ 543	$1,580	$1,580	$ 480
Real estate-commercial	5,586	5,902	593	8,223	8,287	786
Real estate-multi-family	1,666	1,758	118	1,681	1,774	122
Real estate-residential	2,370	2,461	217	2,429	2,483	179
Consumer	134	134	24	210	210	28
Subtotal	$11,344	$11,843	$ 1,495	$14,123	$14,334	$ 1,595
Total:						
Commercial	$2,258	$2,277	$ 543	$2,828	$2,987	$ 480
Real estate-commercial	13,883	14,985	593	19,105	19,890	786
Real estate-multi-family	1,666	1,758	118	1,681	1,774	122
Real estate-construction	256	256	—	263	263	—
Real estate-residential	2,370	2,461	217	2,429	2,483	179
Consumer	170	243	24	247	319	28
	$20,603	$21,980	$ 1,495	$26,553	$27,716	$ 1,595

The following table presents the average balance related to impaired loans and leases for the periods indicated (in thousands):

	Average Recorded Investments for the three months ended		Average Recorded Investments for the six months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Commercial	$ 2,388	$ 5,256	$ 2,339	$ 5,123
Real estate-commercial	15,877	17,743	14,146	15,899
Real estate-multi-family	1,675	1,187	1,673	1,228
Real estate-construction	260	1,937	259	1,852
Real estate-residential	2,403	2,253	2,400	1,543
Leases	—	4	—	—
Agriculture	—	395	—	495
Consumer	210	457	175	212
Total	$ 22,813	$ 29,232	$ 20,992	$ 26,352

The following table presents the interest income recognized on impaired loans and leases for the periods indicated (in thousands):

	Interest Income Recognized for the three months ended		Interest Income Recognized for the six months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Commercial	$ 16	$ 23	$ 32	$ 74
Real estate-commercial	85	210	293	330
Real estate-multi-family	20	15	39	30
Real estate-construction	4	—	7	—
Real estate-residential	29	25	52	45
Consumer	1	3	2	8
Total	$ 155	$ 276	$ 425	$ 487

7. TROUBLED DEBT RESTRUCTURINGS

At June 30, 2013, there were 25 loans and leases that were considered to be troubled debt restructurings. Of these loans and leases, 11 were modified and are currently performing (less than ninety days past due) totaling $4,620,000 and 14 are considered nonperforming (and included in the $5,364,000 discussed in Note 6), totaling $3,728,000. Of the 14 TDRs considered nonperforming, seven are current to the modified terms. At December 31, 2012, there were 42 loans and leases that were considered to be troubled debt restructurings. Of these loans and leases, 29 were modified and are currently performing (less than ninety days past due) totaling $14,906,000 and 13 are considered nonperforming (and included in the $5,474,000 discussed in Note 6), totaling $2,461,000. Of the 13 TDRs considered nonperforming, six are current to the modified terms. At June 30, 2013 and December 31, 2012, there were no unfunded commitments on those loans considered troubled debt restructures. See also "Impaired Loans and Leases" in "Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations."

The Company has allocated $945,000 and $1,575,000 of specific reserves to loans whose terms have been modified as troubled debt restructurings as of June 30, 2013 and December 31, 2012.

During the six-month period ended June 30, 2013, the terms of four loans were modified as a troubled debt restructuring. The modifications of the terms of these loans were extensions of the maturity date and/or interest rates lower than the original loan rate.

The following table presents loans by class modified as troubled debt restructurings during the three months ended June 30, 2013 (dollars in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Real estate – commercial	3	$ 762	$ 722
Total	3	$ 762	$ 722

The following table presents loans by class modified as troubled debt restructurings during the six months ended June 30, 2013 (dollars in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Real estate – commercial	4	$ 1,200	$ 1,160
Total	4	$ 1,200	$ 1,160

The troubled debt restructurings described above increased the allowance for loan and lease losses by $100,000 and resulted in $40,000 in charge-offs during the six months ended June 30, 2013.

The following table presents loans by class modified as troubled debt restructurings during the three months ended June 30, 2012 (dollars in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Commercial	4	$ 646	$ 646
Real estate – commercial	4	1,299	1,299
Real estate – multi-family	1	274	274
Total	9	$ 2,219	$ 2,219

The following table presents loans by class modified as troubled debt restructurings during the six months ended June 30, 2012 (dollars in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Commercial	5	$ 693	$ 693
Real estate – commercial	6	3,509	3,509
Real estate – multi-family	2	539	539
Real estate – residential	3	921	808
Other – agriculture	1	410	410
Other – consumer	2	31	31
Total	19	$ 6,103	$ 5,990

The troubled debt restructurings described above increased the allowance for loan and lease losses by $96,000 and resulted in charge-offs of $113,000 during the six months ended June 30, 2012.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the period indicated (dollars in thousands):

Six months ended June 30, 2013	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Commercial	1	$ 513
Total	1	$ 513

Three months ended June 30, 2012	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Real estate-commercial	2	$ 1,097
Consumer	1	5
Total	3	$ 1,102

Six months ended June 30, 2012	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Real estate – commercial	6	$ 2,357
Commercial	1	863

Consumer	1	5
Total	8	$ 3,225

There were no payment defaults on troubled debt restructurings within 12 months following the modification for the three months ended June 30, 2013.

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8. ALLOWANCE FOR LOAN AND LEASE LOSSES

The Company's loan and lease portfolio allocated by management's internal risk ratings as of June 30, 2013 and December 31, 2012 are summarized below:

June 30, 2013 (dollars in thousands)	Credit Risk Profile by Internally Assigned Grade				
		Real Estate			
	Commercial	Commercial	Multi-family	Construction	Residential
Grade:					
Pass	$23,411	$137,096	$ 8,105	$ 2,476	$ 12,764
Watch	1,340	14,052	1,169	3,406	3,519
Special mention	553	16,309	431	596	1,292
Substandard	1,508	13,128	510	—	787
Doubtful	242	—	—	—	—
Total	$27,054	$180,585	$ 10,215	$ 6,478	$ 18,362

	Credit Risk Profile by Internally Assigned Grade			
	Other Credit Exposure			
	Leases	Agriculture	Consumer	Total
Grade:				
Pass	$ 1,172	$ 2,810	$ 6,343	$194,177
Watch	—	—	25	23,511
Special mention	—	397	130	19,708
Substandard	—	—	133	16,066
Doubtful	—	—	—	242
Total	$ 1,172	$ 3,207	$ 6,631	$253,704

December 31, 2012 (dollars in thousands)	Credit Risk Profile by Internally Assigned Grade				
		Real Estate			
	Commercial	Commercial	Multi-family	Construction	Residential
Grade:					
Pass	$25,670	$134,969	$ 7,018	$ 3,049	$ 13,283
Watch	1,994	14,613	1,181	3,262	2,518
Special mention	653	16,041	441	607	1,163
Substandard	1,804	14,503	515	—	737
Doubtful	690	—	—	—	—
Total	$30,811	$180,126	$ 9,155	$ 6,918	$ 17,701

	Credit Risk Profile by Internally Assigned Grade			
	Other Credit Exposure			
	Leases	Agriculture	Consumer	Total
Grade:				
Pass	$ 1,506	$ 2,938	$ 7,696	$196,129
Watch	—	—	251	23,819
Special mention	—	402	153	19,460

Substandard	3	—	469	18,031
Doubtful	—	—	—	690
Total	$ 1,509	$ 3,340	$ 8,569	$258,129

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The allocation of the Company's allowance for loan and lease losses and by portfolio segment and by impairment methodology are summarized below:

June 30, 2013 (dollars in thousands)		Real Estate				Other				
	Com-mercial	Com-mercial	Multi-Family	Construc-tion	Residential	Leases	Agri-culture	Consumer	Unallocated	Total
Allowance for Loan and Lease Losses										
Beginning balance, January 1, 2013	$1,351	$2,526	$238	$594	$477	$3	$87	$262	$243	$5,781
Provision for loan losses	(158)	402	9	(172)	115	—	4	(87)	87	200
Loans charged off	(11)	(355)	—	—	(38)	—	—	(5)	—	(409)
Recoveries	97	11	—	—	—	—	—	—	—	108
Ending balance, June 30, 2013	$1,279	$2,584	$247	$422	$554	$3	$91	$170	$330	$5,680
Ending balance: Individually evaluated for impairment	$543	$593	$118	$—	$217	$—	$—	$24	$—	$1,495
Ending balance: Collectively evaluated for impairment	$736	$1,991	$129	$422	$337	$3	$91	$146	$330	$4,185
Loans										
Ending balance	$27,054	$180,585	$10,215	$6,478	$18,362	$1,172	$3,207	$6,631	$—	$253,704
Ending balance: Individually evaluated for impairment	$2,258	$13,883	$1,665	$256	$2,370	$—	$—	$171	$—	$20,603
Ending balance: Collectively evaluated for impairment	$24,796	$166,702	$8,550	$6,222	$15,992	$1,172	$3,207	$6,460	$—	$233,101
Allowance for Loan and Lease Losses										
	$1,331	$2,667	$256	$430	$501	$3	$91	$249	$375	$5,903

Beginning balance, March 31, 2013										
Provision for loan losses	(74)	262	(9)	(8)	53	—	—	(79)	(45)	100
Loans charged off	(1)	(355)	—	—	—	—	—	—	—	(356)
Recoveries	23	10	—	—	—	—	—	—	—	33
Ending balance, June 30, 2013	$1,279	$2,584	$247	$422	$554	$3	$91	$170	$330	$5,680

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December 31, 2012

(dollars in thousands)

		Real Estate				Other				
	Com-mercial	Com-mercial	Multi-Family	Construc-tion	Residential	Leases	Agri-culture	Consumer	Unallocated	Total
Ending balance: Individually evaluated for impairment	$480	$786	$122	$—	$179	$—	$—	$28	$—	$1,595
Ending balance: Collectively evaluated for impairment	$871	$1,740	$116	$594	$298	$3	$87	$234	$243	$4,186
<u>Loans</u>										
Ending balance	$30,811	$180,126	$9,155	$6,918	$17,701	$1,509	$3,340	$8,569	$—	$258,129
Ending balance: Individually evaluated for impairment	$2,828	$19,105	$1,681	$263	$2,429	$—	$—	$247	$—	$26,553
Ending balance: Collectively evaluated for impairment	$27,983	$161,021	$7,474	$6,655	$15,272	$1,509	$3,340	$8,322	$—	$231,576

June 30, 2012

(dollars in thousands)		Real Estate				Other				
	Com-mercial	Com-mercial	Multi-Family	Construc-tion	Residential	Leases	Agri-culture	Consumer	Unallocated	Total
<u>Allowance for Loan and Lease Losses</u>										
Beginning balance, January 1, 2012	$1,536	$3,156	$198	$582	$609	$79	$167	$348	$366	$7,041
Provision for loan losses	(320)	703	70	(151)	6	(76)	241	510	(28)	955
Loans charged off	(151)	(845)	(8)	(82)	(113)	(8)	(202)	(492)		(1,901)
Recoveries	—	65	3	22	—	6	—	10		106
Ending balance, June 30, 2012	$1,065	$3,079	$263	$371	$502	$1	$206	$376	$338	$6,201

Allowance for Loan and Lease Losses										
Beginning balance, March 31, 2012	$945	$2,959	$296	$467	$713	$7	$254	$373	$251	$6,265
Provision for loan losses	223	333	(32)	(40)	(211)	(12)	(48)	75	87	375
Loans charged off	(103)	(234)	—	(78)	—	—	—	(82)	—	(497)
Recoveries	—	21	(1)	22	—	6-	—	10	—	58
Ending balance, June 30, 2012	$1,065	$3,079	$263	$371	$502	$1	$206	$376	$338	$6,201

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The Company’s aging analysis of the loan and lease portfolio at June 30, 2013 and December 31, 2012 are summarized below:

June 30, 2013 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	Past Due Greater Than 90 Days	Total Past Due	Current	Total Loans	Past Due Greater Than 90 Days and Accruing	Nonaccrual
Commercial:								
Commercial	$ 10	$ 29	$ 1,702	$ 1,741	$25,313	$ 27,054	—	$ 1,744
Real estate:								
Commercial	2,012	—	195	2,207	178,378	180,585	—	3,283
Multi-family	—	—	—	—	10,215	10,215	—	—
Construction	—	—	—	—	6,478	6,478	—	—
Residential	—	—	173	173	18,189	18,362	—	173
Other:								
Leases	—	—	—	—	1,172	1,172	—	—
Agriculture	—	—	—	—	3,207	3,207	—	—
Consumer	2	99	—	101	6,530	6,631	—	164
Total	$ 2,024	$ 128	$ 2,070	$ 4,222	$249,482	$ 253,704	$ —	$ 5,364

December 31, 2012 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	Past Due Greater Than 90 Days	Total Past Due	Current	Total Loans	Past Due Greater Than 90 Days and Accruing	Nonaccrual
Commercial:								
Commercial	$ 804	$ —	$ 1,497	$ 2,301	$28,510	$ 30,811	—	$ 2,352
Real estate:								
Commercial	—	703	700	1,403	178,723	180,126	—	2,687
Multi-family	—	—	—	—	9,155	9,155	—	—
Construction	—	—	—	—	6,918	6,918	—	—
Residential	—	—	210	210	17,491	17,701	—	210
Other:								
Leases	—	—	3	3	1,506	1,509	—	3
Agriculture	—	—	—	—	3,340	3,340	—	—
Consumer	—	60	114	174	8,395	8,569	—	222
Total	$ 804	$ 763	$ 2,524	$ 4,091	$254,038	$ 258,129	$ —	$ 5,474

9. BORROWING ARRANGEMENTS

At June 30, 2013, the Company had $17,000,000 of unsecured short-term borrowing arrangements with two of its correspondent banks. There were no advances under the borrowing arrangements as of June 30, 2013 or December 31, 2012.

The Company has a line of credit available with the Federal Home Loan Bank of San Francisco (the "FHLB") which is secured by pledged mortgage loans and investment securities. Borrowings may include overnight advances as well as loans with terms of up to thirty years. Advances (both short-term and long-term) totaling $16,000,000 were outstanding from the FHLB at June 30, 2013, bearing interest rates ranging from 0.67% to 2.73% and maturing between January 13, 2014 and July 12, 2019. Advances totaling $18,000,000 were outstanding from the FHLB at December 31, 2012, bearing interest rates ranging from 0.67% to 2.73% and maturing between May 20, 2013 and July 12, 2019. Remaining amounts available under the borrowing arrangement with the FHLB at June 30, 2013 and December 31, 2012 totaled $58,603,000 and $59,254,000, respectively. In addition, the Company has a secured borrowing agreement with the Federal Reserve Bank of San Francisco. The borrowing can be secured by pledging selected loans and investment securities. Borrowings generally are short-term including overnight advances as well as loans with terms up to ninety days. Amounts available under this borrowing arrangement at June 30, 2013 and December 31, 2012 were $23,421,000 and $27,448,000, respectively. The decreased borrowing capacity during 2013 resulted from the decrease in the pledged loan collateral. There were no advances outstanding under this borrowing arrangement as of June 30, 2013 and December 31, 2012.

10. INCOME TAXES

The Company files its income taxes on a consolidated basis with its subsidiaries. The allocation of income tax expense (benefit) represents each entity's proportionate share of the consolidated provision for (benefit from) income taxes.

The Company accounts for income taxes using the balance sheet method, under which deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if applicable, is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company recognizes accrued interest and penalties related to unrecognized tax benefits, if applicable, as a component of interest expense in the consolidated statement of income. There have been no unrecognized tax benefits or accrued interest and penalties for the three-months and six-month periods ended June 30, 2013 and 2012.

The combined federal and state effective tax rate for the quarter ended June 30, 2013 was 28.5%, an increase from 23.9% for the second quarter of 2012. For the six months ended June 30, 2013, the combined federal and state effective tax rate was 24.1% compared to 26.5% for the six months ended June 30, 2012. The lower combined federal and state effective tax rate for the six month periods resulted from lower pretax income in 2013 and the tax-free bank owned life insurance increased significantly in 2013 due to the death benefit proceeds of a life insurance policy on a former director.

11. FAIR VALUE MEASUREMENTS

The following tables present information about the Company’s assets and liabilities measured at fair value on a recurring and nonrecurring basis as of June 30, 2013 and December 31, 2012. They indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

Estimated fair values are disclosed for financial instruments for which it is practicable to estimate fair value. These estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Company’s entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The carrying amounts and estimated fair values of the Company’s financial instruments are as follows (dollars in thousands):

	Carrying	Fair Value Measurements Using:			
June 30, 2013	Amount	Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and due from banks	$23,694	$23,694			$23,694
Interest-bearing deposits in banks	1,000		1,002		1,002
Available-for-sale securities	254,644	40	254,604		254,644
Held-to-maturity securities	1,497		1,586		1,586
FHLB stock	3,248	N/A	N/A	N/A	N/A
Net loans and leases:	247,778			248,308	248,308
Accrued interest receivable	1,886			1,886	1,886
Financial liabilities:					
Deposits:					
Noninterest-bearing	$138,463	$138,463			$138,463
Savings	50,731	50,731			50,731
Money market	127,062	127,062			127,062
NOW accounts	54,952	54,952			54,952
Time, $100,000 or more	71,994		72,802		72,802
Other time	24,455		24,651		24,651
Short-term borrowings	8,000	8,000			8,000
Long-term borrowings	8,000		7,847		7,847
Accrued interest payable	141		141		141

December 31, 2012	Carrying Amount	Fair Value Measurements Using: Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and due from banks	$54,461	$55,461			$55,461
Interest-bearing deposits in banks	750		$750		750
Available-for-sale securities	231,839	15	231,824		231,839
Held-to-maturity securities	2,117		2,255		2,255
FHLB stock	3,254	N/A	N/A	N/A	N/A
Net loans and leases:	252,118			$253,455	253,455
Accrued interest receivable	1,872			1,872	1,872
Financial liabilities:					
Deposits:					
Noninterest-bearing	$151,201	$151,201			$151,201
Savings	51,539	51,539			51,539
Money market	127,644	127,644			127,644
NOW accounts	50,891	50,891			50,891
Time, $100,000 or more	71,145		$71,904		71,904
Other time	25,836		26,068		26,068
Short-term borrowings	2,000	2,000			2,000
Long-term borrowings	16,000		16,147		16,147
Accrued interest payable	162		162		162

Because no market exists for a significant portion of the Company’s financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented.

The following methods and assumptions were used by the Company to estimate the fair values of its financial instruments at June 30, 2013 and December 31, 2012:

<u>Cash and due from banks</u>: The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

<u>Interest-bearing deposits in banks:</u> The fair values of interest-bearing deposits in banks are estimated by discounting their future cash flows using rates at each reporting date for instruments with similar remaining maturities offered by comparable financial institutions and are classified as Level 2.

<u>Investment securities:</u> For investment securities, fair values are based on quoted market prices, where available, and are classified as Level 1. If quoted market prices are not available, fair values are estimated using quoted market prices for similar securities and indications of value provided by brokers and are classified as Level 2.

<u>Loans and leases:</u> Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality also resulting in a Level 3 classification. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB stock: It is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Deposits: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. For time deposits, the fair values for fixed rate certificates of deposit are estimated using a discounted cash flow methodology that applies market interest rates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Short-term and long-term borrowings: The fair value of short-term borrowings is estimated to be the carrying amount and is classified as Level 1. The fair value of long-term borrowings is estimated using a discounted cash flow analysis using interest rates currently available for similar debt instruments and are classified as Level 2.

Accrued interest receivable and payable: The carrying amount of accrued interest receivable approximates fair value resulting in a Level 3 classification and the carrying amount of accrued interest payable approximates fair value resulting in a Level 2 classification.

Off-balance sheet instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments was not material at June 30, 2013 and December 31, 2012.

Assets and liabilities measured at fair value on a recurring and non-recurring basis along with any related gain or loss recognized in the income statement due to fair value changes are presented in the following table:

Description		Fair Value Measurements Using			Total Gains
(dollars in thousands)	Fair Value	Level 1	Level 2	Level 3	(Losses)
June 30, 2013					
Assets and liabilities measured on a recurring basis:					
Available-for-sale securities:					
Mortgage-backed securities	$224,148		$224,148		
Obligations of states and political subdivisions	28,821		28,821		
Corporate bonds	1,576		1,576		
Corporate stock	99	$40	59		
Total recurring	$254,644	$40	$254,604	$—	$ —
Assets and liabilities measured on a nonrecurring basis:					
Impaired loans:					
Commercial	$—	$—	$—	$—	$ —
Real estate:					
Commercial	2,002	—	—	2,002	(70)
Multi-family	—	—	—	—	—
Construction	—	—	—	—	—
Residential	172	—	—	172	(22)
Other:					
Agriculture	—	—	—	—	—
Consumer	—	—	—	—	—
Other real estate owned	8,120	—	—	8,120	(167)
Total nonrecurring	$10,294	$—	$—	$10,294	$ (259)

Description		Fair Value Measurements Using			Total Gains
(dollars in thousands)	Fair Value	Level 1	Level 2	Level 3	(Losses)
December 31, 2012					
Assets and liabilities measured on a recurring basis:					
Available-for-sale securities:					
Mortgage-backed securities	$ 200,515	$—	$ 200,515	$—	$ —
Corporate Debt securities	1,594	—	1,594		
Obligations of states and political subdivisions	29,656	—	29,656	—	—
Corporate stock	74	15	59	—	—
Total recurring	$ 231,839	$ 15	$ 231,824	$—	$ —
Assets and liabilities measured on a nonrecurring basis:					
Impaired loans:					
Commercial	$ 776	$—	$—	$ 776	$ (106)
Real estate:					
Commercial	432	—	—	432	(68)
Construction	210	—	—	210	(72)
Other real estate owned	12,237	—	—	12,237	(1,002)
Total nonrecurring	$ 13,655	$—	$—	$ 13,655	$ (1,248)

There were no significant transfers between Levels 1 and 2 during the three-month and six-month periods ended June 30, 2013 or the twelve months ended December 31, 2012.

The following methods were used to estimate the fair value of each class of financial instrument above:

Available-for-sale securities – Fair values for investment securities are based on quoted market prices, if available, and are considered as Level 1, or evaluated using pricing models that vary by asset class and incorporate available trade, bid and other market information and are considered as Level 2. Pricing applications apply available information, as applicable, through processes such as benchmark curves, benchmarking to like securities, sector groupings and matrix pricing.

Impaired loans – The fair value of collateral dependent impaired loans adjusted for specific allocations of the allowance for loan losses is generally based on recent real estate appraisals and/or evaluations. These appraisals and/or evaluations may utilize a single valuation approach or a combination of approaches including comparable sales, cost and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income and other available data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for all Level 3 nonrecurring loans is the sales comparison approach less a reserve for past dues taxes and selling costs ranging from 8% to 10%.

Other real estate owned – Certain commercial and residential real estate properties classified as other real estate owned (“OREO”) are measured at fair value, less costs to sell. Fair values are based on recent real estate appraisals and/or evaluations. These appraisals and/or evaluations may use a single valuation approach or a combination of approaches including comparable sales, cost and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income and other available data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for all Level 3 nonrecurring OREO is the sales comparison approach less selling costs ranging from 8% to 10%.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following is management's discussion and analysis of the significant changes in American River Bankshares' (the "Company") balance sheet accounts between December 31, 2012 and June 30, 2013 and its income and expense accounts for the three-month and six-month periods ended June 30, 2013 and 2012. The discussion is designed to provide a better understanding of significant trends related to the Company's financial condition, results of operations, liquidity, capital resources and interest rate sensitivity. This discussion and supporting tables and the consolidated financial statements and related notes appearing elsewhere in this report are unaudited. Interest income and net interest income are presented on a fully taxable equivalent basis (FTE) within management's discussion and analysis. Certain matters discussed or incorporated by reference in this Quarterly Report on Form 10-Q including, but not limited to, matters described in "Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations," are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, Section 27A of the Securities Act of 1933, as amended, and subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may contain words related to future projections including, but not limited to, words such as "believe," "expect," "anticipate," "intend," "may," "will," "shou "could," "would," and variations of those words and similar words that are subject to risks, uncertainties and other factors that could cause actual results to differ significantly from those projected. Factors that could cause or contribute to such differences include, but are not limited to, the following:

- the duration of financial and economic volatility and decline and actions taken by the United States Congress and governmental agencies, including the United States Department of the Treasury, to deal with challenges to the U.S. financial system;
- the risks presented by a continued economic recession, which could adversely affect credit quality, collateral values, including real estate collateral, investment values, liquidity and loan originations and loan portfolio delinquency rates;
- variances in the actual versus projected growth in assets and return on assets;
- potential continued or increasing loan and lease losses;
- potential increasing levels of expenses associated with resolving nonperforming assets as well as regulatory changes;
- changes in the interest rate environment including interest rates charged on loans, earned on securities investments and paid on deposits and other borrowed funds;
- competitive effects;
- potential declines in fee and other noninterest income earned associated with economic factors as well as regulatory changes;
- general economic conditions nationally, regionally, and within our operating markets could be less favorable than expected or could have a more direct and pronounced effect on us than expected and adversely affect our ability to continue internal growth at historical rates and maintain the quality of our earning assets;
- changes in the regulatory environment including government intervention in the U.S. financial system;
- changes in business conditions and inflation;

changes in securities markets, public debt markets, and other capital markets;

potential data processing and other operational systems failures or fraud;

potential continued decline in real estate values in our operating markets;

the effects of uncontrollable events such as terrorism, the threat of terrorism or the impact of the current military conflicts in Afghanistan and Iraq and the conduct of the war on terrorism by the United States and its allies, worsening financial and economic conditions, natural disasters, and disruption of power supplies and communications;

changes in accounting standards, tax laws or regulations and interpretations of such standards, laws or regulations;

projected business increases following any future strategic expansion could be lower than expected;

the goodwill we have recorded in connection with acquisitions could become impaired, which may have an adverse impact on our earnings;

the reputation of the financial services industry could experience further deterioration, which could adversely affect our ability to access markets for funding and to acquire and retain customers;

the efficiencies we may expect to receive from any investments in personnel and infrastructure may not be realized; and

downgrades in the credit rating of the United States by credit rating agencies.

The factors set forth under "Item 1A - Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, and other cautionary statements and information set forth in this Quarterly Report on Form 10-Q should be carefully considered and understood as being applicable to all related forward-looking statements contained in this Quarterly Report on Form 10-Q, when evaluating the business prospects of the Company and its subsidiaries.

Forward-looking statements are not guarantees of performance. By their nature, they involve risks, uncertainties and assumptions. The future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. Any such statement speaks only as of the date of this report, and in the case of any documents that may be incorporated by reference, as of the date of those documents. We do not undertake any obligation to update or release any revisions to any forward-looking statements, to report any new information, future event or other circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as required by law. However, your attention is directed to any further disclosures made on related subjects in our subsequent reports filed with the Securities and Exchange Commission (the "SEC") on Forms 10-K, 10-Q and 8-K.

Critical Accounting Policies

General

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses is an estimate of the probable incurred credit loss risk inherent in our loan and lease portfolio as of the balance sheet date. The allowance is based on two basic principles of accounting: (1) "Accounting for Contingencies," which requires that losses be accrued when it is probable that a loss has occurred at the balance sheet date and such loss can be reasonably estimated; and (2) the "Receivables" topic, which requires that losses be accrued on impaired loans based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan or lease balance.

The allowance for loan and lease losses is determined based upon estimates that can and do change when the actual risk, loss events, or changes in other factors, occur. The analysis of the allowance uses an historical loss view as an indicator of future losses and as a result could differ from the actual losses incurred in the future. If the allowance for loan and lease losses falls below that deemed adequate (by reason of loan and lease growth, actual losses, the effect of changes in risk factors, or some combination of these), the Company has a strategy for supplementing the allowance for loan and lease losses, over the short-term. For further information regarding our allowance for loan and lease losses, see "Allowance for Loan and Lease Losses Activity" discussion later in this Item 2.

Stock-Based Compensation

The Company recognizes compensation expense over the vesting period in an amount equal to the fair value of all share-based payments which consist of stock options and restricted stock awarded to directors and employees. The fair value of each stock option award is estimated on the date of grant and amortized over the service period using a Black-Scholes-Merton based option valuation model that requires the use of assumptions. Critical assumptions that affect the estimated fair value of each award include expected stock price volatility, dividend yields, option life and the risk-free interest rate.

Goodwill

Business combinations involving the Company's acquisition of equity interests or net assets of another enterprise or the assumption of net liabilities in an acquisition of branches constituting a business may give rise to goodwill. Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The value of goodwill is ultimately derived from the Company's ability to generate net earnings after the acquisition and is not deductible for tax purposes. A decline in net earnings could be indicative of a decline in the fair value of goodwill and result in impairment. For that reason, goodwill is assessed for impairment on an annual basis. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. At December 31, 2012, the Company's reporting unit had positive equity and the Company elected to perform a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeded its carrying value, including goodwill. The qualitative assessment indicated that it was more likely than not that the fair value of the reporting unit exceeded its carrying value, resulting in no impairment.

Income Taxes

The Company files its income taxes on a consolidated basis with its subsidiaries. The allocation of income tax expense (benefit) represents each entity's proportionate share of the consolidated provision for (benefit from) income taxes.

The Company accounts for income taxes using the balance sheet method, under which deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is, if applicable, reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company recognizes accrued interest and penalties related to unrecognized tax benefits, if applicable, as a component of interest expense in the consolidated statement of income. There were no unrecognized tax benefits or accrued interest and penalties at June 30, 2013 or 2012 or for the three-and six-month periods then ended.

General Development of Business

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was incorporated under the laws of the State of California in 1995. As a bank holding company, the Company is authorized to engage in the activities permitted under the Bank Holding Company Act of 1956, as amended, and regulations thereunder. Its principal office is located at 3100 Zinfandel Drive, Suite 450, Rancho Cordova, California 95670 and its telephone number is (916) 854-0123. The Company employed an equivalent of 103 full-time employees as of June 30, 2013.

The Company owns 100% of the issued and outstanding common shares of its banking subsidiary, American River Bank (the "Bank"), and American River Financial, a California corporation which has been inactive since its incorporation in 2003.

American River Bank was incorporated and commenced business in Fair Oaks, California, in 1983 and thereafter moved its headquarters to Sacramento, California in 1985. American River Bank operates five full service offices in Sacramento and Placer Counties including the main office located at 1545 River Park Drive, Suite 107, Sacramento and branch offices in Sacramento, Fair Oaks, and Roseville; two full service offices in Sonoma County in Healdsburg and Santa Rosa; and three full service banking offices in Amador County in Jackson, Pioneer, and Ione. In addition, American River Bank operates a loan production office in Santa Clara County, in the city of Campbell.

In 2000, the Company acquired North Coast Bank as a separate bank subsidiary. North Coast Bank was incorporated and commenced business in 1990 as Windsor Oaks National Bank in Windsor, California. In 1997, the name was changed to North Coast Bank. Effective December 31, 2003, North Coast Bank was merged with and into American River Bank. On December 3, 2004, the Company acquired Bank of Amador located in Jackson, California. Bank of Amador was merged with and into American River Bank.

The Bank's deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC") up to applicable legal limits. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act includes a permanent increase to $250,000 as the maximum FDIC insurance limit per depositor retroactive to January 1, 2008 and the extension of unlimited FDIC insurance for noninterest-bearing transaction accounts effective December 31, 2010 through December 31, 2012. On November 9, 2010, the FDIC implemented a final rule to permanently increase the maximum insurance limit to $250,000 under the Dodd-Frank Act. The unlimited insurance coverage for noninterest bearing transaction accounts was not extended and terminated on December 31, 2012. The $250,000 maximum deposit insurance amount per depositor remains in effect.

American River Bank does not offer trust services or international banking services and does not plan to do so in the near future. American River Bank's primary business is serving the commercial banking needs of small to mid-sized businesses within those counties listed above. American River Bank accepts checking and savings deposits, offers money market deposit accounts and certificates of deposit, makes secured and unsecured commercial, secured real estate, and other installment and term loans and offers other customary banking services. American River Bank also conducts lease financing for certain types of business equipment. American River Bank owns 100% of two inactive companies, ARBCO and American River Mortgage. ARBCO was formed in 1984 to conduct real estate development and has been inactive since 1995. American River Mortgage has been inactive since its formation in 1994. During 2013, the Company conducted no significant activities other than holding the shares of its subsidiaries. However, it is authorized, with the prior approval of the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the Company's principal regulator, to engage in a variety of activities which are deemed closely related to the business of banking. The common stock of the Company is registered under the Securities Exchange Act of 1934, as amended, and is listed and traded on the Nasdaq Global Select Market under the symbol "AMRB."

Overview

The Company recorded net income of $652,000 for the quarter ended June 30, 2013, which was a decrease of $193,000 compared to $845,000 reported for the same period of 2012. Diluted earnings per share for the second quarter of 2013 were $0.07 compared to $0.09 recorded in the second quarter of 2012. The return on average equity ("ROAE") and the return on average assets ("ROAA") for the second quarter of 2013 were 2.87% and 0.45%, respectively, as compared to 3.64% and 0.58%, respectively, for the same period in 2012.

Net income for the six months ended June 30, 2013 and 2012 was $1,274,000 and $1,557,000, respectively, with diluted earnings per share of $0.14 in 2013 and $0.16 in 2012. For the first six months of 2013, ROAE was 2.79% and ROAA was 0.44% compared to 3.33% and 0.54%, respectively, for the same period in 2012.

Total assets of the Company decreased by $18,844,000 (3.2%) from $596,389,000 at December 31, 2012 to $577,545,000 at June 30, 2013. Net loans totaled $247,778,000 at June 30, 2013, down $4,340,000 (1.7%) from $252,118,000 at December 31, 2012. Deposit balances at June 30, 2013 totaled $467,657,000, down $10,599,000 (2.2%) from the $478,256,000 at December 31, 2012.

The Company ended the second quarter of 2013 with a leverage capital ratio of 12.6%, a Tier 1 capital ratio of 23.3%, and a total risk-based capital ratio of 24.5% compared to 12.8%, 23.9%, and 25.1%, respectively, at December 31, 2012. Table One below provides a summary of the components of net income for the periods indicated (See the "Results of Operations" section that follows for an explanation of the fluctuations in the individual components).

Table One: Components of Net Income

(dollars in thousands)	For the three months ended June 30, 2013	2012	For the six months ended June 30, 2013	2012
Interest income*	$ 4,627	$ 5,399	$ 9,351	$ 10,983
Interest expense	(375)	(482)	(782)	(984)
Net interest income*	4,252	4,917	8,569	9,999
Provision for loan and lease losses	(100)	(375)	(200)	(955)
Noninterest income	448	694	1,073	1,387
Noninterest expense	(3,612)	(4,051)	(7,614)	(8,163)
Provision for income taxes	(260)	(265)	(405)	(562)
Tax equivalent adjustment	(76)	(75)	(149)	(149)
Net income	$ 652	$ 845	$ 1,274	$ 1,557
Average total assets	$ 583,550	$ 582,182	$ 584,943	$ 582,163
Net income (annualized) as a percentage of average total assets	0.45 %	0.58 %	0.44 %	0.54 %

*Fully taxable equivalent basis (FTE)

Results of Operations

Net Interest Income and Net Interest Margin

Net interest income represents the excess of interest and fees earned on interest earning assets (loans and leases, securities, Federal funds sold and investments in time deposits) over the interest paid on interest-bearing deposits and borrowed funds. Net interest margin is net interest income expressed as a percentage of average earning assets. The Company’s net interest margin was 3.41% for the three months ended June 30, 2013, 3.93% for the three months ended June 30, 2012, 3.47% for the six months ended June 30, 2013 and 3.97% for the six months ended June 30, 2012.

The fully taxable equivalent interest income component for the second quarter of 2013 decreased $772,000 (14.3%) to $4,627,000 compared to $5,399,000 for the three months ended June 30, 2012. The decrease in the fully taxable equivalent interest income for the second quarter of 2013 compared to the same period in 2012 is broken down by rate (down $392,000) and volume (down $380,000). The rate decrease can be attributed to the overall lower interest rate environment and lower average loan balances replaced with higher average investment securities. While forgone interest on nonaccrual loans has decreased, it continues to negatively impact the yield on earning assets. During the second quarter of 2013, foregone interest income on nonaccrual loans was approximately $109,000, compared to foregone interest of $200,000 during the second quarter of 2012. The foregone interest of $109,000 had an 8 basis point negative impact on the yield on earning assets. The average balance of earning assets decreased $3,774,000 (0.7%) from $503,629,000 in the second quarter of 2012 to $499,855,000 in the second quarter of 2013; however, there was a significant change in the average earning asset mix during these periods, due to an increase in investment securities, offset by a decrease in loan balances. Principal reductions from loan balances were invested into investment securities. When compared to the second quarter of 2012, average loan balances were down $37,669,000 (13.1%) to $250,200,000 for the second quarter of 2013 and average investment securities were up $33,961,000 (15.8%) to $248,817,000 for the second quarter of 2013. The overall low interest rate environment and the change in the asset mix (lower loan totals and higher investment security totals) resulted in a 59 basis point decrease in the yield on average earning assets from 4.31% for the second quarter of 2012 to 3.72% for the second quarter of 2013. The volume decrease of $380,000 occurred mainly as a result of the decrease in average loans. The markets in which the Company operates are seeing marginal demand for new loans while existing borrowers continue to pay down debt and delay expansion plans.

Total fully taxable equivalent interest income for the six months ended June 30, 2013 decreased $1,632,000 (14.9%) to $9,351,000 compared to $10,983,000 for the six months ended June 30, 2012. The breakdown of the fully taxable equivalent interest income for the six months ended June 30, 2013 over the same period in 2012 resulted from decreases in rate (down $775,000) and a decrease in volume (down $857,000). Average earning assets decreased $9,214,000 (1.8%) during the first six months of 2013 as compared to the same period in 2012. Average loan balances decreased $40,413,000 (13.8%) during that same period and average investment securities balances increased $31,500,000 (14.8%).

Interest expense was $375,000 or $107,000 (22.2%) lower in the second quarter of 2013 versus the prior year period. The average balances on interest bearing liabilities were $2,608,000 (0.7%) lower in the second quarter of 2013 compared to the same quarter in 2012. The slightly lower balances did not impact the overall interest expense, as the lower rate was the main cause for the decrease in interest expense. The net $107,000 decrease in interest expense during the second quarter of 2013 compared to the second quarter of 2012 was due to lower rates (down $111,000) and volume (up $4,000). The Company focused its marketing efforts on replacing higher cost time deposits with lower cost checking, savings, and money market accounts. Average time deposit balances were down $4,294,000 (4.3%) during the second quarter of 2013 compared to the second quarter of 2012. In addition, the Company is strategically managing the interest expense by reducing some of the higher interest rate tiered money market accounts and this led to a decrease in average interest checking and money market accounts from $181,611,000 in the second quarter of 2012 to $180,993,000 during the second quarter of 2013. The decrease was offset by an increase in noninterest bearing deposits from $134,611,000 in the second quarter of 2012 to $141,661,000 during the second quarter of 2013 and an increase in borrowings from $14,000,000 in the second quarter of 2012 to $17,170,000 during the second quarter of 2013. The Company continues to have success attracting new deposit relationships as a direct result of its business development efforts. The decrease of $111,000 in rates is a result of the lower overall interest rate environment. Rates paid on interest bearing liabilities decreased 12 basis points from 0.56% to 0.44% for the second quarter of 2012 compared to the second quarter of 2013.

Interest expense was $202,000 (20.5%) lower in the six-month period ended June 30, 2013 versus the prior year period. The average balances on interest-bearing liabilities were $2,280,000 (0.7%) lower in the six-month period ended June 30, 2013 compared to the same period in 2012. While the average balances where lower, especially in the level of average time deposits, the Company experienced an increase in borrowings which resulted in an overall volume related increase in interest expense of $4,000. Average time deposit balances were down $3,033,000 (3.0%) during the first six months of 2013 compared to the first six months of 2012 and increased borrowings of $2,786,000 (18.8%) during the same time period. The increased borrowing resulted from the Company locking in some low-cost and long term funding. The decrease in interest expense was primarily the result of lower rates, which accounted for an $111,000 decrease in interest expense for the six-month period June 30, 2013. Rates paid on interest-bearing liabilities decreased 11 basis points from 0.57% for the first six months of 2012 to 0.46% for the first six months of 2013.

Table Two, Analysis of Net Interest Margin on Earning Assets, and Table Three, Analysis of Volume and Rate Changes on Net Interest Income and Expenses, are provided to enable the reader to understand the components and trends of the Company’s interest income and expenses. Table Two provides an analysis of net interest margin on earning assets setting forth average assets, liabilities and shareholders’ equity; interest income earned and interest expense paid and average rates earned and paid; and the net interest margin on earning assets. Table Three sets forth a summary of the changes in interest income and interest expense from changes in average asset and liability balances (volume) and changes in average interest rates.

Table Two: Analysis of Net Interest Margin on Earning Assets

Three Months Ended June 30,	2013				2012			
(Taxable Equivalent Basis) (dollars in thousands)	Avg Balance	Interest	Avg Yield (4)		Avg Balance	Interest	Avg Yield (4)	
Assets								
Earning assets:								
Loans and leases (1)	$250,200	$3,516	5.65	%	$287,869	$4,238	5.92	%
Taxable investment Securities	219,057	805	1.48	%	185,300	857	1.86	%
Tax-exempt investment securities (2)	29,720	295	3.99	%	29,547	297	4.04	%
Corporate stock (2)	40	11	110.60	%	9	4	178.75	%
Federal funds sold	—	—	—		—	—	—	
Investments in time deposits	838	—	—		904	3	1.33	%
Total earning assets	499,855	4,627	3.72	%	503,629	5,399	4.31	%
Cash & due from banks	41,613				38,085			
Other assets	48,059				46,801			
Allowance for loan & lease losses	(5,977)				(6,333)			
	$583,550				$582,182			
Liabilities & Shareholders' Equity								
Interest bearing liabilities:								
Interest checking and money market	$180,993	120	0.27	%	$181,611	170	0.38	%
Savings	50,357	18	0.14	%	51,223	31	0.24	%
Time deposits	96,647	163	0.68	%	100,941	217	0.86	%
Other borrowings	17,170	74	1.73	%	14,000	64	1.84	%
Total interest bearing liabilities	345,167	375	0.44	%	347,775	482	0.56	%
Noninterest bearing demand deposits	141,661				134,611			
Other liabilities	5,615				6,364			
Total liabilities	492,443				488,750			
Shareholders' equity	91,107				93,432			
	$583,550				$582,182			
Net interest income & margin (3)		$4,252	3.41	%		$4,917	3.93	%

(1) Loan interest includes loan fees of $14,000 and $7,000, respectively, during the three months ended June 30, 2013 and June 30, 2012. Average loan balances include non-performing loans.

(2) Includes taxable-equivalent adjustments that primarily relate to income on certain securities that is exempt from federal income taxes. The effective federal statutory tax rate was 34% for 2013 and 2012.

(3) Net interest margin is computed by dividing net interest income by total average earning assets.

(4) Average yield is calculated based on actual days in the period (91 days in 2013 and 92 in 2012) and annualized to actual days in the year (365 days for 2013 and 366 days for 2012).

Six Months Ended June 30,	2013				2012			
(Taxable Equivalent Basis) (dollars in thousands)	Avg Balance	Interest	Avg Yield (4)		Avg Balance	Interest	Avg Yield (4)	
Assets								
Earning assets:								
Loans and leases (1)	$252,072	$7,158	5.73	%	$292,485	$8,554	5.88	%
Taxable investment securities	215,122	1,593	1.49	%	184,138	1,821	1.99	%
Tax-exempt investment securities (2)	29,658	588	4.00	%	29,179	598	4.12	%
Corporate stock (2)	28	11	79.22	%	9	4	89.38	%
Federal funds sold	—	—	—		—	—	—	
Interest-bearing deposits in banks	794	1	0.25	%	1,077	6	1.12	%
Total earning assets	497,674	9,351	3.79	%	506,888	10,983	4.36	%
Cash & due from banks	43,563				35,493			
Other assets	49,625				46,439			
Allowance for loan & lease losses	(5,919)				(6,657)			
	$584,943				$582,163			
Liabilities & Shareholders' Equity								
Interest-bearing liabilities:								
Interest checking and money market	$179,652	248	0.28	%	$182,653	362	0.40	%
Savings	50,818	42	0.17	%	49,850	60	0.24	%
Time deposits	96,881	342	0.71	%	99,914	431	0.87	%
Other borrowings	17,583	150	1.72	%	14,797	131	1.78	%
Total interest-bearing liabilities	344,934	782	0.46	%	347,214	984	0.57	%
Noninterest-bearing demand deposits	141,712				134,690			
Other liabilities	6,105				6,301			
Total liabilities	492,751				488,205			
Shareholders' equity	92,192				93,958			
	$584,943				$582,163			
Net interest income & margin (3)		$8,569	3.47	%		$9,999	3.97	%

(1) Loan interest includes loan fees of $74,000 and $11,000, respectively, during the six months ended June 30, 2013 and June 30, 2012. Average loan balances include non-performing loans.

(2) Includes taxable-equivalent adjustments that primarily relate to income on certain securities that is exempt from federal income taxes. The effective federal statutory tax rate was 34% for 2013 and 2012.

(3) Net interest margin is computed by dividing net interest income by total average earning assets.

(4) Average yield is calculated based on actual days in the period (181 days in 2013 and 182 in 2012) and annualized to actual days in the year (365 days for 2013 and 366 days for 2012).

Table Three: Analysis of Volume and Rate Changes on Net Interest Income and Expenses

Three Months Ended June 30, 2013 over 2012 (dollars in thousands)

Increase (decrease) due to change in:

Interest-earning assets:	Volume	Rate (4)	Net Change
Net loans (1)(2)	$ (550)	$ (172)	$ (722)
Taxable investment securities	155	(207)	(52)
Tax exempt investment securities (3)	1	(3)	(2)
Corporate stock	14	(7)	7
Federal funds sold	—	—	—
Interest-bearing deposits in banks	—	(3)	(3)
Total	(380)	(392)	(772)
Interest-bearing liabilities:			
Interest checking and money market	(1)	(49)	(50)
Savings deposits	(1)	(12)	(13)
Time deposits	(9)	(45)	(54)
Other borrowings	15	(5)	10
Total	4	(111)	(107)
Interest differential	$ (384)	$ (281)	$ (665)

Six Months Ended June 30, 2013 over 2012 (dollars in thousands)

Increase (decrease) due to change in:

Interest-earning assets:	Volume	Rate (4)	Net Change
Net loans (1)(2)	$(1,179)	$(217)	$ (1,396)
Taxable investment securities	306	(534)	(228)
Tax exempt investment securities (3)	10	(20)	(10)
Corporate stock	8	(1)	7
Federal funds sold	—	—	—
Interest-bearing deposits in banks	(2)	(3)	(5)
Total	(857)	(775)	(1,632)
Interest-bearing liabilities:			
Interest checking and money market	(6)	(108)	(114)
Savings deposits	1	(19)	(18)
Time deposits	(13)	(76)	(89)
Other borrowings	23	(4)	19
Total	5	(207)	(202)
Interest differential	$(862)	$(568)	$ (1,430)

(1) The average balance of non-accruing loans is immaterial as a percentage of total loans and, as such, has been included in net loans.

(2) Loan fees of $14,000 and $7,000, respectively, during the three months ended June 30, 2013 and June 30, 2012, and loan fees of $74,000 and $11,000, respectively, during the six months ended June 30, 2013 and June 30, 2012, have been included in the interest income computation.

(3) Includes taxable-equivalent adjustments that primarily relate to income on certain securities that is exempt from federal income taxes. The effective federal statutory tax rate was 34% for 2013 and 2012.

(4) The rate/volume variance has been included in the rate variance.

Provision for Loan and Lease Losses

The Company provided $100,000 for loan and lease losses for the second quarter of 2013 as compared to $375,000 for the second quarter of 2012. Net loan and lease losses for the three months ended June 30, 2013 were $323,000 or 0.52% (on an annualized basis) of average loans and leases as compared to $439,000 or 0.61% (on an annualized basis) of average loans and leases for the three months ended June 30, 2012. For the first six months of 2013, the Company made provisions for loan and lease losses of $200,000 and net loan and lease losses were $301,000 or 0.24% (on an annualized basis) of average loans and leases outstanding. This compares to provisions for loan and lease losses of $955,000 and net loan and lease losses of $1,795,000 for the first six months of 2012 or 1.23% (on an annualized basis) of average loans and leases outstanding. While the allowance for loan and lease losses ("ALLL") has decreased in 2013 due to specific reserves being charged against the ALLL, the Company has continued to add to the ALLL for 2013 as we continue to have a higher than historical average level of nonperforming loans and leases. The high level of nonperforming loans and leases is due to the impact that the overall challenging economy in the Company's market areas and in the United States, has had on the Company's borrowers. For additional information see the "Allowance for Loan and Lease Losses Activity."

Noninterest Income

Table Four below provides a summary of the components of noninterest income for the periods indicated (dollars in thousands):

Table Four: Components of Noninterest Income

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Service charges on deposit accounts	$ 147	$ 194	$ 298	$ 390
Gain on sale/call of securities	3	11	3	75
Merchant fee income	111	135	218	263
Bank owned life insurance	51	66	241	132
Income from OREO properties	71	229	163	392
Other	65	59	150	135
Total noninterest income	$ 448	$ 694	$ 1,073	$ 1,387

Noninterest income decreased $246,000 (35.4%) to $448,000 for the three months ended June 30, 2013 as compared to $694,000 for the three months ended June 30, 2012. The decrease from the second quarter of 2012 to the second quarter of 2013 was primarily related to lower service charges on deposit accounts and lower rents received on properties obtained through foreclosure. For the second quarter of 2013, service charges on deposit accounts were $147,000 compared to $194,000 in the second quarter of 2012 and rental income was $71,000 compared to $229,000 in the second quarter of 2012. The decrease in service charges is primarily related to lower fees collected on overdrawn deposit accounts and the decrease in income from the rental properties results primarily from lower rents received from foreclosed office buildings, as the Company has been able to sell many of the properties. For the six months ended June 30, 2013, noninterest income decreased $314,000 (22.6%) to $1,073,000. The decrease from the first six months of 2012 compared to the same period in 2013 was also related to lower service charges and lower rents received on properties obtained through foreclosure. In addition, gains on sale of investment securities decreased from $75,000 in 2012 to $3,000 in 2013 as the Company sold fewer investment securities during 2013. These decreases were partially offset by higher income from bank owned life insurance, primarily from death benefit proceeds of a life insurance policy on a former director, resulting in tax-free income of $118,000.

Noninterest Expense

Noninterest expense decreased $439,000 (10.8%) to a total of $3,612,000 in the second quarter of 2013 compared to $4,051,000 in the second quarter of 2012. Salary and employee benefits expense increased $142,000 (7.0%) from $2,033,000 during the second quarter of 2012 to $2,175,000 during the second quarter of 2013. Salaries increased $49,000 (3.2%) from $1,545,000 in the second quarter of 2012 to $1,594,000 in the second quarter of 2013 as a result on normal merit increases and incentive accruals increased from zero in the second quarter of 2012 to $88,000 in the second quarter of 2013, primarily due to an increase in the Company’s net income in relationship to targeted net income. These incentive accruals are estimates based on full year results and will be adjusted before the end of the year when actual results are known. On a quarter-over-quarter basis, occupancy expense increased $2,000 and furniture and equipment expense decreased $11,000. FDIC assessments decreased $157,000 (111.3%) during the second quarter of 2013 to a credit balance of $16,000, from $141,000 in the second quarter of 2012. OREO related expenses decreased $273,000 (58.3%) during the second quarter of 2013 to $195,000, from $468,000 in the second quarter of 2012. Other expenses decreased $142,000 (15.6%) to a total of $766,000 in the second quarter of 2013 compared to $908,000 in the second quarter of 2012. The decrease in the FDIC assessments relates to an adjustment to the FDIC accrual based upon a normal updated analysis revealing that the accrual should be reduced. The primary reason for the decrease in OREO related expenses is due to the sale of a number of properties, including office buildings which have high operating expenses. The primary decreases in other expenses relates to a decrease in expenses related to amortization of intangible assets, which decreased from $50,000 in the second quarter of 2012 to zero in the second quarter of 2013 as the intangible asset became fully depreciated in 2012 and professional fees decreased $57,000 from $246,000 in the second quarter of 2012 to $189,000 in the second quarter of 2013, due in part to lower legal and other professional services to resolve problem loans.

The fully taxable equivalent efficiency ratio for the second quarter of 2013 increased to 76.9% from 71.3% for the second quarter of 2012. Since the Company experienced a decrease in noninterest expense during this time period the increase in the efficiency is related to a decrease in the net interest margin.

Noninterest expense for the six-month period ended June 30, 2013 was $7,614,000 versus $8,163,000 for the same period in 2012 for a decrease of $549,000 (6.7%). Salaries and benefits expense increased $158,000 (3.7%) from $4,235,000 for the six months ended June 30, 2012 to $4,393,000 for the same period in 2013. Salaries increased $39,000 (1.3%) from $3,113,000 in 2012 to $3,152,000 in 2013 and incentive accruals increased from $99,000 in 2012 to $213,000 in 2013. Occupancy expense increased $7,000 and furniture and equipment expense decreased $7,000. FDIC assessments decreased $173,000 (61.1%) during 2013 to $110,000, from $283,000 in 2012. OREO related expenses decreased $342,000 (40.6%) during 2013 to $500,000, from $842,000 in 2012. Other expenses decreased $192,000 (10.6%) from $1,816,000 for the six months ended June 30, 2012 to $1,624,000 for the same period in 2013. The decrease in other expenses results from the Company's focus on reducing controllable expenses and a reduction in legal fees and expenses related to amortization of intangible assets. Legal expenses are down $50,000 (10.2%), from $490,000 in 2012 to $440,000 in 2013 and the expense related to the amortization of intangible assets decreased from $100,000 during 2012 to zero in 2013.

The overhead efficiency ratio (fully taxable equivalent), excluding the amortization of intangible assets, for the first six months of 2013 was 79.0% as compared to 70.8% in the same period of 2012.

Provision for Income Taxes

Federal and state income taxes for the quarter ended June 30, 2013 decreased $5,000 from $265,000 in the second quarter of 2012 to $260,000 in the second quarter of 2013. The combined federal and state effective tax rate for the quarter ended June 30, 2013 was 28.5%, an increase from 23.9% for the second quarter of 2012. For the six months ended June 30, 2013, the provision for income taxes was $405,000 with a combined federal and state effective tax rate of 24.1%, compared to a provision of $562,000 and a combined federal and state effective tax rate of 26.5% for the six months ended June 30, 2012. The lower level of income taxes and effective tax rate for the six month periods resulted from lower pretax income in 2013 and the tax-free bank owned life insurance increased significantly in 2013 due to the death benefit proceeds of a life insurance policy on a former director.

Balance Sheet Analysis

The Company's total assets were $577,545,000 at June 30, 2013 as compared to $596,389,000 at December 31, 2012, representing a decrease of $18,844,000 (3.2%). The average assets for the three months ended June 30, 2013 were $583,550,000, which represents an increase of $1,368,000 or 0.2% over the balance of $582,182,000 during the three-month period ended June 30, 2012. The average assets for the six months ended June 30, 2013 were $584,943,000, which represents an increase of $2,780,000 or 0.5% from the average balance of $582,163,000 during the six-month period ended June 30, 2012.

Investment Securities

The Company classifies its investment securities as available-for-sale or held-to-maturity. The Company's intent is to hold all securities classified as held-to-maturity until maturity and management believes that it has the ability to do so. Securities available-for-sale may be sold to implement asset/liability management strategies and in response to changes in interest rates, prepayment rates and similar factors. Table Five below summarizes the values of the Company's investment securities held on June 30, 2013 and December 31, 2012.

Table Five: Investment Securities Composition

(dollars in thousands)

Available-for-sale (at fair value)	June 30, 2013	December 31, 2012
Debt securities:		
Mortgage-backed securities	$ 224,148	$ 200,515
Obligations of states and political subdivisions	28,821	29,656
Corporate bonds	1,576	1,594
Corporate stock	99	74
Total available-for-sale investment securities	$ 254,644	$ 231,839
Held-to-maturity (at amortized cost)		
Debt securities:		
Mortgage-backed securities	$ 1,497	$ 2,117
Total held-to-maturity investment securities	$ 1,497	$ 2,117

Net unrealized gains on available-for-sale investment securities totaling $1,314,000 were recorded, net of $876,000 in tax liabilities, as accumulated other comprehensive income within shareholders’ equity at June 30, 2013 and net unrealized gains on available-for-sale investment securities totaling $4,285,000 were recorded, net of $2,857,000 in tax liabilities, as accumulated other comprehensive income within shareholders’ equity at December 31, 2012.

Management periodically evaluates each investment security in a loss position for other than temporary impairment relying primarily on industry analyst reports, observation of market conditions and interest rate fluctuations. Management has the ability and intent to hold securities with established maturity dates until recovery of fair value, which may be until maturity, and believes it will be able to collect all amounts due according to the contractual terms for all of the underlying investment securities; therefore, management does not consider these investments to be other-than-temporarily impaired.

Loans and Leases

The Company concentrates its lending activities in the following principal areas: (1) commercial; (2) commercial real estate; (3) multi-family real estate; (4) real estate construction (both commercial and residential); (5) residential real estate; (6) lease financing receivable; (7) agriculture; and (8) consumer loans. The Company’s continuing focus in our market area, new borrowers developed through the Company’s marketing efforts, and credit extensions expanded to existing borrowers resulted in the Company originating $23 million in new loans during the first half of 2013. Normal pay downs, loan charge-offs, and loans transferred to OREO resulted in a net decrease in total loans and leases of $4.3 million (1.7%) from December 31, 2012. The markets in which the Company operates are seeing marginal new loan volume but existing borrowers continue to pay down debt and delay expansion plans. Table Six below summarizes the composition of the loan portfolio as of June 30, 2013 and December 31, 2012.

Table Six: Loan and Lease Portfolio Composition

(dollars in thousands)	June 30, 2013	December 31, 2012	Change in	Percentage

	$	%	$	%	dollars	change
Commercial	$27,054	11 %	$30,811	12 %	$(3,757)	(12.2 %)
Real estate						
Commercial	180,585	71 %	180,126	70 %	459	0.3 %
Multi-family	10,215	4 %	9,155	3 %	1,060	11.6 %
Construction	6,478	3 %	6,918	3 %	(440)	(6.4 %)
Residential	18,362	7 %	17,701	7 %	661	3.7 %
Lease financing receivable	1,172	0 %	1,509	1 %	(337)	(22.3 %)
Agriculture	3,207	1 %	3,340	1 %	(133)	(4.0 %)
Consumer	6,631	3 %	8,569	3 %	(1,938)	(22.6 %)
Total loans and leases	253,704	100%	258,129	100%	(4,425)	(1.7 %)
Deferred loan and lease fees, net	(246)		(230)		(16)	
Allowance for loan and lease losses	(5,680)		(5,781)		101	
Total net loans and leases	$247,778		$252,118		$(4,340)	(1.7 %)

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A significant portion of the Company's loans and leases are direct loans and leases made to individuals and local businesses. The Company relies substantially on local promotional activity and personal contacts by American River Bank officers, directors and employees to compete with other financial institutions. The Company makes loans and leases to borrowers whose applications include a sound purpose and a viable primary repayment source, generally supported by a secondary source of repayment.

Commercial loans consist of credit lines for operating needs, loans for equipment purchases, working capital, and various other business loan products. Consumer loans include a range of traditional consumer loan products such as personal lines of credit and homeowner equity lines of credit and loans to finance purchases of autos, boats, recreational vehicles, mobile homes and various other consumer items. Construction loans are generally comprised of commitments to customers within the Company's service area for construction of commercial properties, multi-family properties and custom and semi-custom single-family residences. Other real estate loans consist primarily of loans secured by first trust deeds on commercial, multi-family, and residential properties typically with maturities from 3 to 10 years and original loan-to-value ratios generally from 65% to 75%. Agriculture loans consist primarily of vineyard loans and development loans to plant vineyards. In general, except in the case of loans under SBA programs or Farm Services Agency guarantees, the Company does not make long-term mortgage loans.

"Subprime" real estate loans generally refer to residential mortgages made to higher-risk borrowers with lower credit and/or income histories. Within the industry, many of these loans were originated with adjustable interest rates that reset upward after an introductory period. These "subprime" loans coupled with declines in housing prices have led to an increase in the banking industry's default rates resulting in many instances of increased foreclosure rates as the adjustable interest rates reset to higher levels. The Company did not have any such "subprime" loans at June 30, 2013 and December 31, 2012.

Risk Elements

The Company assesses and manages credit risk on an ongoing basis through a total credit culture that emphasizes excellent credit quality, extensive internal monitoring and established formal lending policies. Additionally, the Company contracts with an outside loan review consultant to periodically review the existing loan and lease portfolio. Management believes its ability to identify and assess risk and return characteristics of the Company's loan and lease portfolio is critical for profitability and growth. Management strives to continue its emphasis on credit quality in the loan and lease approval process, through active credit administration and regular monitoring. With this in mind, management has designed and implemented a comprehensive loan and lease review and grading system that functions to continually assess the credit risk inherent in the loan and lease portfolio.

Ultimately, underlying trends in economic and business cycles influence credit quality. American River Bank's business is concentrated in the Sacramento Metropolitan Statistical Area, which is a diversified economy, but with a large State of California government presence and employment base; in Sonoma County, which is focused on businesses within the two communities in which the Bank has offices (Santa Rosa and Healdsburg); and in Amador County, in which the Bank is primarily focused on businesses within the three communities in which it has offices (Jackson, Pioneer, and Ione). The economy of Sonoma County is diversified with professional services, manufacturing, agriculture and real estate investment and construction, while the economy of Amador County is reliant upon government, services, retail trade, manufacturing industries and Indian gaming. The Company has recently entered the Santa Clara County market with a loan production office in Campbell. The economy of Santa Clara County is diversified with professional services, manufacturing, technology related companies, real estate investment and construction.

The Company has significant extensions of credit and commitments to extend credit that are secured by real estate. The ultimate repayment of these loans is generally dependent on personal or business cash flows or the sale or refinancing of the real estate. The Company monitors the effects of current and expected market conditions and other factors on the collectability of real estate loans. The more significant factors management considers involve the following: lease rates and terms, vacancy rates, absorption and sale rates and capitalization rates; real estate values, supply and demand factors, and rates of return; operating expenses; inflation and deflation; and sufficiency of repayment sources independent of the real estate including, in some instances, personal guarantees.

In extending credit and commitments to borrowers, the Company ge