UNITED SECURITY BANCSHARES
Form 10-Q
August 03, 2017
Table of Contents

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2017
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: 000-32897

UNITED SECURITY BANCSHARES
(Exact name of registrant as specified in its charter)

CALIFORNIA	91-2112732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2126 Inyo Street, Fresno, California	93721
(Address of principal executive offices)	(Zip Code)

Registrants telephone number, including area code (559) 248-4943

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing 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, a small reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o
Small reporting company x		Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

Common Stock, no par value
(Title of Class)

Shares outstanding as of July 31, 2017: 16,875,190

1

Table of Contents

TABLE OF CONTENTS

Facing Page

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets	3
Consolidated Statements of Income	4
Consolidated Statements of Comprehensive Income	5
Consolidated Statements of Changes in Shareholders' Equity	6
Consolidated Statements of Cash Flows	7
Notes to Consolidated Financial Statements	8

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	37
Overview	37
Results of Operations	38
Financial Condition	45
Asset/Liability Management – Liquidity and Cash Flow	56
Regulatory Matters	57
Item 4. Controls and Procedures	59

PART II. Other Information

Item 1.	Legal Proceedings	61
Item 1A.	Risk Factors	61
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	61
Item 3.	Defaults Upon Senior Securities	61
Item 4.	Mine Safety Disclosures	61
Item 5.	Other Information	61
Item 6.	Exhibits	61

Signatures	62

Table of Contents

PART I. Financial Information

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets – (unaudited)
June 30, 2017 and December 31, 2016

(in thousands except shares)	June 30, 2017	December 31, 2016
Assets		
Cash and non-interest bearing deposits in other banks	$21,016	$ 25,781
Cash and due from Federal Reserve Bank	88,492	87,251
Cash and cash equivalents	109,508	113,032
Interest-bearing deposits in other banks	652	650
Investment securities available for sale (at fair value)	53,461	57,491
Loans	567,240	569,759
Unearned fees and unamortized loan origination costs, net	923	1,075
Allowance for credit losses	(9,007)	(8,902)
Net loans	559,156	561,932
Accrued interest receivable	5,086	3,895
Premises and equipment – net	10,710	10,445
Other real estate owned	5,745	6,471
Goodwill	4,488	4,488
Cash surrender value of life insurance	19,313	19,047
Investment in limited partnerships	1,666	757
Deferred tax assets - net	3,392	3,298
Other assets	8,389	6,466
Total assets	$781,566	$ 787,972
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$287,003	$ 262,697
Interest bearing	379,308	413,932
Total deposits	666,311	676,629
Accrued interest payable	33	76
Accounts payable and other liabilities	6,260	5,781
Junior subordinated debentures (at fair value)	9,441	8,832
Total liabilities	682,045	691,318
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 16,875,190 issued and outstanding at June 30, 2017, and 16,705,594 at December 31, 2016	57,844	56,557
Retained earnings	42,053	40,701
Accumulated other comprehensive loss	(376)	(604)
Total shareholders' equity	99,521	96,654
Total liabilities and shareholders' equity	$781,566	$ 787,972

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Income
(Unaudited)

	Quarter Ended June 30,		Six Months Ended June 30,	
(In thousands except shares and EPS)	2017	2016	2017	2016
Interest Income:				
Loans, including fees	$7,579	$ 6,658	$14,804	$ 13,288
Investment securities – AFS – taxable	229	185	453	374
Interest on deposits in FRB	301	151	484	276
Interest on deposits in other banks	1	2	2	4
Total interest income	8,110	6,996	15,743	13,942
Interest Expense:				
Interest on deposits	364	272	700	549
Interest on other borrowings	74	58	143	116
Total interest expense	438	330	843	665
Net Interest Income	7,672	6,666	14,900	13,277
(Recovery of Provision) Provision for Credit Losses	(52)	12	(31)	(10)
Net Interest Income after (Recovery of Provision) Provision for Credit Losses	7,724	6,654	14,931	13,287
Noninterest Income:				
Customer service fees	997	1,017	1,938	1,943
Increase in cash surrender value of bank-owned life insurance	134	132	266	264
(Loss) gain on fair value of financial liability	(264)	113	(601)	471
Other	199	165	372	310
Total noninterest income	1,066	1,427	1,975	2,988
Noninterest Expense:				
Salaries and employee benefits	2,586	2,469	5,571	5,058
Occupancy expense	1,043	1,018	2,058	2,115
Data processing	25	26	52	85
Professional fees	345	301	600	790
Regulatory assessments	133	246	269	501
Director fees	75	73	143	143
Correspondent bank service charges	19	19	37	39
Loss on California tax credit partnership	10	37	119	73
Net (gain) cost on operation and sale of OREO	(309)	60	(277)	177
Other	680	575	1,226	1,143
Total noninterest expense	4,607	4,824	9,798	10,124
Income Before Provision for Taxes	4,183	3,257	7,108	6,151
Provision for Taxes on Income	1,691	1,236	2,845	2,361
Net Income	$2,492	$ 2,021	$4,263	$ 3,790
Net Income per common share				
Basic	$0.15	$ 0.12	$0.25	$ 0.22
Diluted	$0.15	$ 0.12	$0.25	$ 0.22
Shares on which net income per common shares were based				
Basic	16,875,190	16,870,113	16,875,134	16,870,113
Diluted	16,894,227	16,875,339	16,891,784	16,874,260

4

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)

(In thousands)	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Net Income	$2,492	$2,021	$4,263	$3,790
Unrealized holdings gain on securities	267	249	355	308
Unrealized gains on unrecognized post-retirement costs	13	12	26	24
Other comprehensive income, before tax	280	261	381	332
Tax expense related to securities	(107)	(99)	(142)	(123)
Tax expense related to unrecognized post-retirement costs	(6)	(5)	(11)	(10)
Total other comprehensive income	167	157	228	199
Comprehensive income	$2,659	$2,178	$4,491	$3,989

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
(unaudited)

(In thousands except shares)	Common stock Number of Shares	Amount	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance December 31, 2015*	16,051,406	$52,572	$37,265	$ (202)	$89,635
*Excludes 15,019 unvested restricted shares					
Other comprehensive income				199	199
Common stock dividends	322,590	1,673	(1,673)		—
Stock-based compensation expense		14			14
Net income			3,790		3,790
Balance June 30, 2016*	16,373,996	$54,259	$39,382	$ (3)	$93,638
*Excludes 12,015 unvested restricted shares					
Other comprehensive loss				(601)	(601)
Common stock dividends	329,135	2,276	(2,276)		—
Common stock issuance	2,463	6			6
Stock-based compensation expense		16			16
Net income			3,595		3,595
Balance December 31, 2016*	16,705,594	$56,557	$40,701	$ (604)	$96,654
*Excludes 12,015 unvested restricted shares					
Other comprehensive income				228	228
Cash dividends on common stock ($0.10 per share)			(1,690)		(1,690)
Common stock dividends	167,082	1,221	(1,221)		—
Stock options exercised	2,514	6			6
Stock-based compensation expense		60			60
Net income			4,263		4,263
Balance June 30, 2017*	16,875,190	$57,844	$42,053	$ (376)	$99,521
*Excludes 9,011 unvested restricted shares					

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Cash Flows (unaudited)

	Six months ended June 30,	
(In thousands)	2017	2016
Cash Flows From Operating Activities:		
Net Income	$4,263	$3,790
Adjustments to reconcile net income:to cash provided by operating activities:		
Recovery of provision for credit losses	(31)	(10)
Depreciation and amortization	654	731
Amortization of investment securities	278	194
Accretion of investment securities	(4)	(19)
Increase in accrued interest receivable	(1,191)	(918)
Decrease in accrued interest payable	(43)	(1)
Decrease in accounts payable and accrued liabilities	(398)	(729)
Decrease (increase) in unearned fees and unamortized loan origination costs, net	152	(1,401)
(Increase) decrease in income taxes receivable	(1,319)	1,956
Stock-based compensation expense	60	14
(Benefit) provision for deferred income taxes	(247)	194
Gain on sale of other real estate owned	(336)	(53)
Increase in cash surrender value of bank-owned life insurance	(266)	(264)
Loss (gain) on fair value option of financial liabilities	601	(471)
Loss on tax credit limited partnership interest	119	73
Net increase in other assets	(42)	(77)
Net cash provided by operating activities	2,250	3,009
Cash Flows From Investing Activities:		
Net increase in interest-bearing deposits with banks	(2)	(4)
Purchase of correspondent bank stock	(495)	(101)
Purchases of available-for-sale securities	—	(14,940)
Principal payments of available-for-sale securities	4,112	3,330
Net decrease (increase) in loans	2,654	(38,919)
Cash proceeds from sales of other real estate owned	1,062	2,410
Payoff of senior liens on other real estate owned	—	(705)
Investment in limited partnership	(1,028)	(66)
Capital expenditures of premises and equipment	(919)	(345)
Net cash provided by (used in) investing activities	5,384	(49,340)
Cash Flows From Financing Activities:		
Net increase in demand deposits and savings accounts	24,885	16,964
Net decrease in time deposits	(35,203)	(1,820)
Proceeds from exercise of stock options	6	—
Dividends on common stock ($0.05 per share)	(846)	—
Net cash (used in) provided by financing activities	(11,158)	15,144
Net decrease in cash and cash equivalents	(3,524)	(31,187)
Cash and cash equivalents at beginning of period	113,032	125,751
Cash and cash equivalents at end of period	$109,508	$94,564

7

Table of Contents

United Security Bancshares and Subsidiaries - Notes to Consolidated Financial Statements - (Unaudited)

1. Organization and Summary of Significant Accounting and Reporting Policies

The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary United Security Bank (the “Bank”) and two bank subsidiaries, USB Investment Trust (the “REIT”) and United Security Emerging Capital Fund (collectively the “Company” or “USB”). Intercompany accounts and transactions have been eliminated in consolidation.

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2016 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Recently Issued Accounting Standards:

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606), which creates Topic 606 and supersedes Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of 2014-09. Multiple ASUs and interpretative guidance have been issued in connection with ASU 2014-09. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new guidance requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The standard is effective for public entities for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company has begun their process to implement this new standard by reviewing all revenue sources to determine the sources that are in scope for this guidance. As a bank, key revenue sources, such as interest income have been identified as out of scope of this new guidance. The Company has not yet determined the financial statement impact this guidance will have.

In January 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-01 Financial Instruments-Overall: Recognition and Measurements of Financial Assets and Financial Liabilities. This ASU requires equity investments to be measured at fair value, with changes in fair value recognized in net income. The amendment also simplifies the impairment assessment of equity investments for which fair value is not readily determinable by requiring an entity to perform a qualitative assessment to identify impairment. The ASU is effective for fiscal years beginning after December 15, 2017, and interim periods therein. The Company expects this ASU to impact its consolidated income and other comprehensive income disclosures for the fair value of its mutual fund investment and junior subordinated debenture.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance

sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification® and creating Topic 842, Leases. This Update, along with IFRS 16, Leases, are the results of the FASB's and the International Accounting Standards Board's (IASB's) efforts to meet that objective and improve financial reporting. This ASU will be effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. Although an estimate of the impact of the new leasing standard has not yet been determined, the Company expects a significant new lease asset and related lease liability on the balance sheet due to the number of leased branches and standalone ATM sites the Bank currently has that are accounted for under current operating lease guidance.

In June 2016, FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326). The FASB is issuing this Update to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The Update requires enhanced disclosures and judgments in estimating credit

Table of Contents

losses and also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company has established a project team for the implementation of this new standard. The team has started by working with a vendor to put a new Allowance for Loan Loss software in place and is collecting additional historical data to estimate the impact of this standard. An estimate of the impact of this standard has not yet been determined, however, the impact is expected to be significant.

As of January 1, 2017, the Company adopted the Financial Accounting Standards Board's (FASB) Accounting Standard Update ("ASU") No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. ASU 2016-09, seeks to simplify several aspects of the accounting for employee share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. As required by ASU 2016-09, all adjustments are reflected as of the beginning of the fiscal year, January 1, 2016. By applying this ASU, the Company no longer adjusts common stock for the tax impact of shares released, instead the tax impact is recognized as tax expense in the period the shares are released. This simplifies the tracking of the excess tax benefits and deficiencies, but could cause volatility in tax expense for the periods presented. The statement of cash flows has been adjusted to reflect the provisions of this ASU. The application of this ASU did not have a material impact on the financial statements.

In January 2017, FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350). The FASB is issuing this Update to eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value. This ASU will be effective for public business entities for annual periods beginning after December 15, 2019 (i.e. calendar periods beginning on January 1, 2020, and interim periods therein. The Company does not expect any impact on the Company's consolidated financial statements resulting from the adoption of this update.

In March 2017, FASB issued ASU 2017-08 - Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The provisions of the update require premiums recognized upon the purchase of callable debt securities to be amortized to the earliest call date in order to avoid losses recognized upon call. For public business entities that are SEC filers the amendments of the update will become effective in fiscal years beginning after December 15, 2018. The Company does not expect the requirements of this update to have a material impact on the Company’s financial position, results of operations or cash flows.

2. Investment Securities

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of June 30, 2017 and December 31, 2016:

(in 000's) June 30, 2017 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$ 21,344	$ 322	$ (7)	$ 21,659
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	28,130	80	(188)	28,022
Mutual Funds	4,000	—	(220)	3,780
Total securities available for sale	$ 53,474	$ 402	$ (415)	$ 53,461

Table of Contents

(in 000's) December 31, 2016 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$ 22,992	$ 280	$ (69)	$ 23,203
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	30,867	107	(402)	30,572
Mutual Funds	4,000	—	(284)	3,716
Total securities available for sale	$ 57,859	$ 387	$ (755)	$ 57,491

The amortized cost and fair value of securities available for sale at June 30, 2017, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

	June 30, 2017	
(in 000's)	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	$4,000	$ 3,780
Due after one year through five years	—	—
Due after five years through ten years	792	808
Due after ten years	20,552	20,851
Collateralized mortgage obligations	28,130	28,022
	$53,474	$ 53,461

There were no realized gains or losses on sales of available-for-sale securities for the three and six month periods ended June 30, 2017 and June 30, 2016. There were no other-than-temporary impairment losses for the three and six month periods ended June 30, 2017 and June 30, 2016.

At June 30, 2017, available-for-sale securities with an amortized cost of approximately $18,005,228 (fair value of $18,196,687) were pledged as collateral for FHLB borrowings and public funds balances.

The Company had no held-to-maturity or trading securities at June 30, 2017 or December 31, 2016.

Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other-than-temporary.

The following summarizes temporarily impaired investment securities:

(in 000's)	Less than 12 Months		12 Months or More		Total	
June 30, 2017 Securities available for sale:	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
U.S. Government agencies	$3,874	$ —	3,509	(7)	$7,383	$ (7)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	17,175	(115)	7,359	(73)	24,534	(188)

Mutual Funds	—	—	3,780	(220)	3,780	(220)
Total impaired securities	$21,049	$ (115)	$14,648	$ (300)	$35,697	$ (415)
December 31, 2016						
Securities available for sale:						
U.S. Government agencies	$12,281	$ (69)	$—	$ —	$12,281	$ (69)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	25,904	(402)	—	—	25,904	(402)
Mutual Funds	—	—	3,716	(284)	3,716	(284)
Total impaired securities	$38,185	$ (471)	$3,716	$ (284)	$41,901	$ (755)

Temporarily impaired securities at June 30, 2017, were comprised of one mutual fund, two U.S. government agency securities, and twelve U.S. government sponsored entities and agencies collateralized by mortgage obligations securities.

The Company evaluates investment securities for other-than-temporary impairment (OTTI) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, Investments – Debt and Equity Instruments. Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated under ASC Topic 325-40, Beneficial Interest in Securitized Financial Assets.

In the first segment, the Company considers many factors in determining OTTI, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to the Company at the time of the evaluation.

The second segment of the portfolio uses the OTTI guidance that is specific to purchased beneficial interests including private label mortgage-backed securities. Under this model, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

Additionally, other-than-temporary-impairment occurs when the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If the Company intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary-impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary-impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary-impairment related to the credit loss is recognized in earnings, and is determined based on the difference between the present value of cash flows expected to be collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At June 30, 2017, the decline in fair value of the impaired mutual fund, the two U.S. government agency securities, and the twelve U.S. government sponsored entities and agencies collateralized by mortgage obligations securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities, and it is not more likely than not that it will be required to sell these securities before its anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at June 30, 2017.

3. Loans

Loans are comprised of the following:

(in 000's)	June 30, 2017	December 31, 2016
Commercial and Business Loans	$51,078	$ 47,464
Government Program Loans	1,393	1,541
Total Commercial and Industrial	52,471	49,005
Real Estate – Mortgage:		
Commercial Real Estate	202,364	200,213
Residential Mortgages	79,319	87,388
Home Improvement and Home Equity loans	572	599
Total Real Estate Mortgage	282,255	288,200
Real Estate Construction and Development	124,749	130,687
Agricultural	58,432	56,918
Installment	49,333	44,949
Total Loans	$567,240	$ 569,759

The Company's loans are predominantly in the San Joaquin Valley and the greater Oakhurst/East Madera County area, as well as the Campbell area of Santa Clara County. Although the Company does participate in loans with other financial institutions, they are primarily in the state of California.

Commercial and industrial loans represent 9.3% of total loans at June 30, 2017 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 49.8% of total loans at June 30, 2017, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings, shopping centers; apartments and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment.

Table of Contents

Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

- Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and a majority are conventional mortgages that were purchased as a pool. Most residential mortgages originated by the Company are of a shorter term than conventional mortgages, with maturities ranging from 3 to 15 years on average.

- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans, and are offered to borrowers for the purpose of home improvements, although the proceeds may be used for other purposes. Home equity loans are generally secured by junior trust deeds, but may be secured by 1st trust deeds.

Real estate construction and development loans, representing 22.0% of total loans at June 30, 2017, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 10.3% of total loans at June 30, 2017 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 8.7% of total loans at June 30, 2017 and generally consist of student loans, loans to individuals for household, family and other personal expenditures such as credit cards, automobiles or other consumer items. Included in installment loans are $42,983,000 in student loans made to medical and pharmacy school students. Repayment on student loans is deferred until 6 months after graduation. Accrued interest on loans that have not entered repayment status totaled $3,131,000 at June 30, 2017.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At June 30, 2017 and December 31, 2016, these financial instruments include commitments to extend credit of $102,616,000 and $120,485,000, respectively, and standby letters of credit of $1,630,000 and $1,201,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the consolidated balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company’s exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. A majority of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

11

Table of Contents

Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. The following is a summary of delinquent loans at June 30, 2017 (in 000's):

June 30, 2017	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$ 422	$ 22	$ 87	$ 531	$ 50,547	$ 51,078	$ 87
Government Program Loans	—	—	280	280	1,113	1,393	—
Total Commercial and Industrial	422	22	367	811	51,660	52,471	87
Commercial Real Estate Loans	—	—	—	—	202,364	202,364	—
Residential Mortgages	—	—	—	—	79,319	79,319	—
Home Improvement and Home Equity Loans	—	—	—	—	572	572	—
Total Real Estate Mortgage	—	—	—	—	282,255	282,255	—
Real Estate Construction and Development Loans	—	—	—	—	124,749	124,749	—
Agricultural Loans	—	—	—	—	58,432	58,432	—
Consumer Loans	—	—	—	—	49,146	49,146	—
Overdraft Protection Lines	—	—	—	—	46	46	—
Overdrafts	—	—	—	—	141	141	—
Total Installment	—	—	—	—	49,333	49,333	—
Total Loans	$ 422	$ 22	$ 367	$ 811	$ 566,429	$ 567,240	$ 87

The following is a summary of delinquent loans at December 31, 2016 (in 000's):

December 31, 2016	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$ —	$ 432	$ —	$ 432	$ 47,032	$ 47,464	$ —
Government Program Loans	—	—	290	290	1,251	1,541	—
Total Commercial and Industrial	—	432	290	722	48,283	49,005	—
Commercial Real Estate Loans	—	—	—	—	200,213	200,213	—
Residential Mortgages	—	—	—	—	87,388	87,388	—
Home Improvement and Home Equity Loans	—	—	—	—	599	599	—
Total Real Estate Mortgage	—	—	—	—	288,200	288,200	—
Real Estate Construction and Development Loans	166	—	1,250	1,416	129,271	130,687	1,250
Agricultural Loans	—	—	—	—	56,918	56,918	—
Consumer Loans	—	—	965	965	43,785	44,750	—
Overdraft Protection Lines	—	—	—	—	48	48	—
Overdrafts	—	—	—	—	151	151	—
Total Installment	—	—	965	965	43,984	44,949	—
Total Loans	$ 166	$ 432	$ 2,505	$ 3,103	$ 566,656	$ 569,759	$ 1,250

Nonaccrual Loans

Commercial, construction and commercial real estate loans are placed on nonaccrual status under the following circumstances:

Table of Contents

- When there is doubt regarding the full repayment of interest and principal.

- When principal and/or interest on the loan has been in default for a period of 90-days or more, unless the asset is both well secured and in the process of collection that will result in repayment in the near future.

- When the loan is identified as having loss elements and/or is risk rated "8" Doubtful.

Other circumstances which jeopardize the ultimate collectability of the loan including certain troubled debt restructurings, identified loan impairment, and certain loans to facilitate the sale of OREO.

Loans meeting any of the preceding criteria are placed on nonaccrual status and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

All other loans where principal or interest is due and unpaid for 90 days or more are placed on nonaccrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

When a loan is placed on nonaccrual status and subsequent payments of interest (and principal) are received, the interest received may be accounted for in two separate ways.

Cost recovery method: If the loan is in doubt as to full collection, the interest received in subsequent payments is diverted from interest income to a valuation reserve and treated as a reduction of principal for financial reporting purposes.

Cash basis: This method is only used if the recorded investment or total contractual amount is expected to be fully collectible, under which circumstances the subsequent payments of interest are credited to interest income as received.

Loans on non-accrual status are usually not returned to accrual status unless all delinquent principal and/or interest has been brought current, there is no identified element of loss, and current and continued satisfactory performance is expected (loss of the contractual amount not the carrying amount of the loan). Return to accrual is generally demonstrated through the timely receipt of at least six monthly payments on a loan with monthly amortization.

Nonaccrual loans totaled $5,508,000 and $7,264,000 at June 30, 2017 and December 31, 2016, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at June 30, 2017 or December 31, 2016.

The following is a summary of nonaccrual loan balances at June 30, 2017 and December 31, 2016 (in 000's).

	June 30, 2017	December 31, 2016
Commercial and Business Loans	$281	$ 275
Government Program Loans	280	290
Total Commercial and Industrial	561	565
Commercial Real Estate Loans	473	1,126
Residential Mortgages	—	—
Home Improvement and Home Equity Loans	—	—

Total Real Estate Mortgage	473	1,126
Real Estate Construction and Development Loans	4,474	4,608
Agricultural Loans	—	—
Consumer Loans	—	965
Overdraft Protection Lines	—	—
Overdrafts	—	—
Total Installment	—	965
Total Loans	$5,508	$ 7,264

Table of Contents

Impaired Loans

A loan is considered impaired when based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement.

The Company applies its normal loan review procedures in making judgments regarding probable losses and loan impairment. The Company evaluates for impairment those loans on nonaccrual status, graded doubtful, graded substandard or those that are troubled debt restructures. The primary basis for inclusion in impaired status under generally accepted accounting pronouncements is that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement.

A loan is not considered impaired if there is merely an insignificant delay or shortfall in the amounts of payments and the Company expects to collect all amounts due, including interest accrued, at the contractual interest rate for the period of the delay.

Review for impairment does not include large groups of smaller balance homogeneous loans that are collectively evaluated to estimate the allowance for loan losses. The Company's present allowance for loan losses methodology, including migration analysis, captures required reserves for these loans in the formula allowance.

For loans determined to be impaired, the Company evaluates impairment based upon either the fair value of underlying collateral, discounted cash flows of expected payments, or observable market price.

- For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable. For loans that are not considered collateral dependent, a discounted cash flow methodology is used.

- The discounted cash flow method of measuring the impairment of a loan is used for impaired loans that are not considered to be collateral dependent. Under this method, the Company assesses both the amount and timing of cash flows expected from impaired loans. The estimated cash flows are discounted using the loan's effective interest rate. The difference between the amount of the loan on the Bank's books and the discounted cash flow amounts determines the amount of impairment to be provided. This method is used for most of the Company's troubled debt restructurings or other impaired loans where some payment stream is being collected.

- The observable market price method of measuring the impairment of a loan is only used by the Company when the sale of loans or a loan is in process.

The method for recognizing interest income on impaired loans is dependent on whether the loan is on nonaccrual status or is a troubled debt restructure. For income recognition, the existing nonaccrual and troubled debt restructuring policies are applied to impaired loans. Generally, except for certain troubled debt restructurings which are performing under the restructure agreement, the Company does not recognize interest income received on impaired loans, but reduces the carrying amount of the loan for financial reporting purposes.

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves for loan utilizing the discounted cash flow method, or charge-offs for collateral-based impaired loans, or those using observable market pricing.

14

Table of Contents

The following is a summary of impaired loans at June 30, 2017 (in 000's).

June 30, 2017	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and Business Loans	$ 3,934	$ 595	$ 3,355	$ 3,950	$ 693	$ 4,315	$ 132
Government Program Loans	395	337	59	396	18	366	12
Total Commercial and Industrial	4,329	932	3,414	4,346	711	4,681	144
Commercial Real Estate Loans	1,062	—	1,066	1,066	216	1,204	44
Residential Mortgages	2,668	515	2,163	2,678	225	2,357	73
Home Improvement and Home Equity Loans	—	—	—	—	—	—	—
Total Real Estate Mortgage	3,730	515	3,229	3,744	441	3,561	117
Real Estate Construction and Development Loans	6,868	6,878	—	6,878	—	6,709	231
Agricultural Loans	1,050	—	1,056	1,056	793	874	54
Consumer Loans	—	—	—	—	—	643	—
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	—	—	—	—	—	643	—
Total Impaired Loans	$ 15,977	$ 8,325	$ 7,699	$ 16,024	$ 1,945	$ 16,468	$ 546

(1) The recorded investment in loans includes accrued interest receivable of $47,000.
(2) Information is based on the six month period ended June 30, 2017.

Table of Contents

The following is a summary of impaired loans at December 31, 2016 (in 000's).

December 31, 2016	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and Business Loans	$ 4,635	$ 495	$ 4,158	$ 4,653	$ 757	$ 5,050	$ 302
Government Program Loans	356	356	—	356	—	372	20
Total Commercial and Industrial	4,991	851	4,158	5,009	757	5,422	322
Commercial Real Estate Loans	1,454	—	1,456	1,456	450	1,503	89
Residential Mortgages	2,467	526	1,949	2,475	153	2,874	138
Home Improvement and Home Equity Loans	—	—	—	—	—	—	—
Total Real Estate Mortgage	3,921	526	3,405	3,931	603	4,377	227
Real Estate Construction and Development Loans	6,267	6,274	—	6,274	—	8,794	361
Agricultural Loans	—	—	—	—	—	5	8
Consumer Loans	965	965	—	965	—	968	35
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	965	965	—	965	—	968	35
Total Impaired Loans	$ 16,144	$ 8,616	$ 7,563	$ 16,179	$ 1,360	$ 19,566	$ 953

(1) The recorded investment in loans includes accrued interest receivable of $35,000.
(2) Information is based on the twelve month period ended December 31, 2016.

In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructurings for which the loan is performing under the current contractual terms for a reasonable period of time, income is recognized under the accrual method.

The average recorded investment in impaired loans for the quarters ended June 30, 2017 and 2016 was $16,881,000 and $23,163,000, respectively. Interest income recognized on impaired loans for the quarters ended June 30, 2017 and 2016 was approximately $323,000 and $317,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately $111,000 and $87,000 for the quarters ended June 30, 2017 and 2016, respectively.

The average recorded investment in impaired loans for the six months ended June 30, 2017 and 2016 was $16,468,000 and $23,336,000, respectively. Interest income recognized on impaired loans for the six months ended June 30, 2017 and 2016 was approximately $546,000 and $680,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately $190,000 and $236,000 for the six months ended June 30, 2017 and 2016, respectively.

Table of Contents

Troubled Debt Restructurings

In certain circumstances, when the Company grants a concession to a borrower as part of a loan restructuring, the restructuring is accounted for as a troubled debt restructuring (TDR). TDRs are reported as a component of impaired loans.

A TDR is a type of restructuring in which the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession (either imposed by court order, law, or agreement between the borrower and the Bank) to the borrower that it would not otherwise consider. Although the restructuring may take different forms, the Company's objective is to maximize recovery of its investment by granting relief to the borrower.

A TDR may include, but is not limited to, one or more of the following:

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.

- A modification of terms of a debt such as one or a combination of:

The reduction (absolute or contingent) of the stated interest rate.
The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.
The reduction (absolute or contingent) of accrued interest.

For a restructured loan to return to accrual status there needs to be, among other factors, at least 6 months successful payment history. In addition, the Company performs a financial analysis of the credit to determine whether the borrower has the ability to continue to meet payments over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and cash flow analysis of the borrower. Only after determination that the borrower has the ability to perform under the terms of the loans, will the restructured credit be considered for accrual status. Although the Company does not have a policy which specifically addresses when a loan may be removed from TDR classification, as a matter of practice, loans classified as TDRs generally remain classified as such until the loan either reaches maturity or its outstanding balance is paid off.

Table of Contents

The following tables illustrates TDR activity for the periods indicated:

($ in 000's)	Three Months Ended June 30, 2017				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	$ —	$ —	—	$ —
Government Program Loans	1	178	178	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	1	238	238	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—
Total Loans	2	$ 416	$ 416	—	$ —

($ in 000's)	Six Months Ended June 30, 2017				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	1	$ 69	$ 69	—	$ —
Government Program Loans	1	178	178	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	1	238	238	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
Real Estate Construction and Development Loans	1	790	790	—	—
Agricultural Loans	1	850	850	—	—
Consumer Loans	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—
Total Loans	5	$ 2,125	$ 2,125	—	$ —

Table of Contents

($ in 000's)	Three Months Ended June 30, 2016				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	1	$ 395	$ 227	—	$ —
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—			