NATIONAL STEEL CO
Form 6-K
July 23, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 6-K

Report of Foreign Private Issuer
Pursuant to Rule 13a-16 or 15d-16 of the
Securities Exchange Act of 1934

For the month of July, 2007

Commission File Number 1-14732

COMPANHIA SIDERÚRGICA NACIONAL

(Exact name of registrant as specified in its charter)

National Steel Company

(Translation of Registrant's name into English)

Av. Brigadeiro Faria Lima 3400, 20º andar
São Paulo, SP, Brazil
04538-132
(Address of principal executive office)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F ___X___ Form 40-F _______

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes _______ No ___X____

MATERIAL FACT
COMPANHIA SIDERRGICA NACIONAL
Publicly-held Company
Rua São José n.° 20, Grupo 1602, parte
Rio de Janeiro/RJ
Corporate Taxpayer s ID (CNPJ/MF): 33.042.730/0001 -04

COMPANHIA SIDERÚRGICA NACIONAL (CSN), pursuant to Article 157 of Law 6,404/76 and CVM Instruction 358/02, hereby informs its shareholders and the general public that on July 20, 2007, its wholly-owned subsidiary NACIONAL MINÉRIOS S.A. (NAMISA) entered into a purchase agreement with the shareholders of Cia. de Fomento Mineral e Participaes CFM (CFM) for the acquisition of 100% of the shares issued and outstanding by CFM.

CFM explores various iron ore mines and owns ore processing facilities in the state of Minas Gerais. CFM sold approximately 3.6 million tonnes of iron ore in 2006 and in the first half of 2007 sold approximately 2.7 million tonnes. The company is enlarging the production capacity of its facilities and in 2008, CFM s sales are expected to reach 8 million tonnes of iron ore.

The acquisition price may amount up to US$440 million, of which US$100 million was paid upon the execution of the purchase agreement, and US$250 million will be paid on August 1st, 2007. The remaining US$90 million may be paid in four installments within two years upon the fulfillment of certain conditions of the purchase agreement. The financial resources for the acquisition of CFM shall be obtained with funds raised in the financial markets.

The acquisition of CFM by NAMISA represents another step in CSN s strategy of conquering a larger share of the mining sector, thus, increasing its potential of creating value for its shareholders

Rio de Janeiro, July 23, 2007.

Companhia Siderúrgica Nacional
Benjamin Steinbruch
Investor Relations Executive Officer

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: July 23, 2007

COMPANHIA SIDERÚRGICA NACIONAL

By: /s/ Benjamin Steinbruch

Benjamin Steinbruch
Chief Executive Officer and
Investor Relations Officer

By: /s/ Otávio de Garcia Lazcano

Otávio de Garcia Lazcano
Chief Financial Officer

FORWARD-LOOKING STATEMENTS

This press release may contain forward-looking statements. These statements are statements that are not historical facts, and are based on management's current view and estimates of future economic circumstances, industry conditions, company performance and financial results. The words "anticipates", "believes", "estimates", "expects", "plans" and similar expressions, as they relate to the company, are intended to identify forward-looking statements. Statements regarding the declaration or payment of dividends, the implementation of principal operating and financing strategies and capital expenditure plans, the direction of future operations and the factors or trends affecting financial condition, liquidity or results of operations are examples of forward-looking statements. Such statements reflect the current views of management and are subject to a number of risks and uncertainties. There is no guarantee that the expected events, trends or results will actually occur. The statements are based on many assumptions and factors, including general economic and market conditions, industry conditions, and operating factors. Any changes in such assumptions or factors could cause actual results to differ materially from current expectations.

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or subordinated debt securities due September 23, 2036 in order to supplement regulatory capital. These junior subordinated debt securities are senior to the shares of our common stock. As a result, we must make interest payments on the debentures before any dividends can be paid on our common stock, and in the event of our bankruptcy, dissolution or liquidation, the holders of the debt securities must be paid in full before any distributions may be made to the holders of our common stock. In addition, we have the right to defer interest payments on the junior subordinated debt securities for up to five years, during which time no dividends may be paid to holders of our common stock. In the event that the Bank is unable to pay dividends to us, then we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and, thus, we would be unable to declare and pay any dividends on our common stock.

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Provisions in our articles of incorporation could delay or prevent changes in control of our corporation or our management. Our articles of incorporation contain provisions for staggered terms of office for members of the board of directors; no cumulative voting in the election of directors; and the requirement that our board of directors consider the potential social and economic effects on our employees, depositors, customers and the communities we serve as well as certain other factors, when evaluating a possible tender offer, merger or other acquisition of the Company. These provisions make it more difficult for another company to acquire us, which could cause our shareholders to lose an opportunity to be paid a premium for their shares in an acquisition transaction, and reduce the current and future market price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. Properties

The Company's administrative headquarters is located at 86 North Main Street, Porterville, California, in a 37,000 square feet, three-story office building of which the Company is sole occupant. The Company purchased this office building in December 2011 in a cash transaction, from parties unrelated to the Company. The Company's main office is located at 90 N. Main Street, Porterville, California, adjacent to its administrative headquarters, and consists of a one-story brick building on unencumbered property owned by us. The Company also owns unencumbered property on which 14 of our other offices are located, namely the following branches: Porterville West Olive, Bakersfield Ming, California City, Dinuba, Exeter, Farmersville, Fresno Shaw, Hanford, Lindsay, Tehachapi Downtown, Tehachapi Old Town, Three Rivers, Tulare, and Visalia Mooney. The remaining branches, as well as our technology center in Porterville and our six remote ATM locations, are all leased from unrelated parties. While limited branch expansion is planned over the course of the next few years, management believes that existing back-office facilities are adequate to accommodate the Company's operations for the immediately foreseeable future.

Item 3. Legal Proceedings

From time to time, the Company is a party to claims and legal proceedings arising in the ordinary course of business. After taking into consideration information furnished by counsel to the Company as to the current status of these claims or proceedings to which the Company is a party, management is of the opinion that the ultimate aggregate liability represented thereby, if any, will not have a material adverse affect on the financial condition of the Company.

Item 4. RESERVED

PART II

Item 5. Market for REGISTRANT'S Common Equity, Related Shareholder Matters AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Market Information

Sierra Bancorp's Common Stock trades on the NASDAQ Global Select Market under the symbol BSRR, and the CUSIP number for our stock is #82620P102. Trading in the Company's Common Stock has not consistently occurred in high volumes, and such trading activity cannot always be characterized as constituting an active trading market. The following table summarizes trades of the Company's Common Stock, setting forth the approximate high and low sales prices and volume of trading for the periods indicated, based upon information provided by public sources.

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Calendar Quarter Ended	Sale Price of the Company's Common Stock (per share) High	Low	Approximate Trading Volume In Shares
March 31, 2011	$ 11.20	$ 10.38	1,444,602
June 30, 2011	$ 11.73	$ 10.58	1,233,723
September 30, 2011	$ 11.70	$ 8.47	1,499,721
December 31, 2011	$ 11.49	$ 8.51	1,744,827
March 31, 2012	$ 10.21	$ 8.73	1,472,347
June 30, 2012	$ 10.20	$ 8.42	1,302,810
September 30, 2012	$ 13.00	$ 9.35	1,218,617
December 31, 2012	$ 12.72	$ 9.80	1,437,301

(b) Holders

As of January 31, 2013 there were approximately 4,001 shareholders of the Company's Common Stock. Per our stock transfer agent there were 562 registered holders of record, and per Broadridge, an investor communication company, there were approximately 3,439 beneficial holders with shares being held under a street name on that date, including "objecting beneficial owners" whose names and addresses are unavailable.

(c) Dividends

The Company paid cash dividends totaling $3.4 million, or $0.24 per share in 2012 and 2011, representing 41% of annual net earnings for dividends paid in 2012 and 43% in 2011. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to its growth capacity. However, at a time when many of our peers elected to suspend dividend payments, at least temporarily, the Company's Board also concluded that a certain level of dividend should be maintained as long as our core operating performance remains adequate and policy or regulatory restrictions do not preclude such payments, without regard to peer payout ratios. While we maintained a consistent level of quarterly dividends in 2011 and 2012, no assurance can be given that our financial performance in any given year will justify the continued payment of a certain level of cash dividend, or any cash dividend at all.

As a bank holding company that currently has no significant assets other than its equity interest in the Bank, the Company's ability to declare dividends depends upon cash on hand as supplemented by dividends it might receive from the Bank. The Bank's dividend practices in turn depend upon the Bank's earnings, financial position, current and anticipated capital requirements, and other factors deemed relevant by the Bank's Board of Directors at that time. The power of the Bank's Board of Directors to declare cash dividends is also subject to statutory and regulatory restrictions. Under California banking law, the Bank may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three years (reduced by dividends paid during such period) or, with the prior approval of the California Commissioner of Financial Institutions, in an amount not exceeding the greatest of (i) the retained earnings of the Bank, (ii) the net income of the Bank for its last fiscal year, or (iii) the net income of the Bank for its current fiscal year. The payment of any cash dividends by the Bank will depend not only upon the Bank's

earnings during a specified period, but also on the Bank meeting certain regulatory capital requirements.

The Company's ability to pay dividends is also limited by state law. The California General Corporation Law allows a California corporation to pay dividends if the company's retained earnings equal at least the amount of the proposed dividend. If a California corporation does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if immediately after the dividend the sum of the company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities. In addition, during any period in which the Company has deferred payment of interest otherwise due and payable on its subordinated debt securities, it may not make any dividends or distributions with respect to its capital stock (see "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources").

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(d) Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information as of December 31, 2012, with respect to options outstanding and available under our 2007 Stock Incentive Plan and the now-terminated 1998 Stock Option Plan, which are our only equity compensation plans other than an employee benefit plan meeting the qualification requirements of Section 401(a) of the Internal Revenue Code:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders	926,950	$ 14.16	733,640

(e) Performance Graph

The following is a five-year performance graph comparing the total cumulative shareholder return on the Company's common stock to the cumulative total returns of the NASDAQ Composite Index (a broad equity market index), the SNL Bank Index, and the SNL $1 billion to $5 billion (asset size) Bank Index (the latter two qualifying as peer bank indices), assuming a $100 investment on December 31, 2007 and reinvestment of dividends:

	Period Ending					
Index	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
Sierra Bancorp	100.00	87.16	32.84	47.16	39.55	52.62
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
SNL Bank $1B-$5B	100.00	82.94	59.45	67.39	61.46	75.78
SNL Bank	100.00	57.06	56.47	63.27	49.00	66.13

Source : SNL Financial LC, Charlottesville, VA

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(f) Stock Repurchases

The Company has a non-expiring stock repurchase program that became effective July 1, 2003, under which all share repurchases are executed in accordance with SEC Rule 10b-18. The amount available for repurchase has been supplemented from time to time, as deemed appropriate by the Board of Directors. There were no stock repurchases during the fourth quarter of 2012, leaving 100,669 shares available for repurchase as of December 31, 2012. The Company has not repurchased any shares for the past few years due to economic uncertainties and the perceived need for capital preservation. However, in January 2013, the Board reactivated the Company’s stock repurchase plan and increased the total number of shares authorized for repurchase to 700,000, or approximately 5% of total issued and outstanding shares.

Item 6. Selected Financial Data

The following table presents selected historical financial information concerning the Company, which should be read in conjunction with our audited consolidated financial statements, including the related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” included elsewhere herein. The selected financial data as of December 31, 2012 and 2011, and for each of the years in the three year period ended December 31, 2012, is derived from our audited consolidated financial statements and related notes which are included in this Annual Report. The selected financial data presented for earlier years is derived from our audited financial statements which are not included in this Annual Report. Throughout this Annual Report, information is for the consolidated Company unless otherwise stated.

Selected Financial Data

(dollars in thousands, except per share data)

	As of and for the years ended December 31,				
Income Statement Summary	2012	2011	2010	2009	2008
Interest income	$54,902	$58,614	$63,831	$70,146	$77,938
Interest expense	4,321	5,657	7,649	12,177	21,329
Net interest income before provision for loan losses	50,581	52,957	56,182	57,969	56,609
Provision for loan losses	14,210	12,000	16,680	21,574	19,456
Non-interest income	18,126	14,992	19,265	17,279	15,987
Non-interest expense	46,656	47,605	51,638	44,138	35,859
Income before provision for income taxes	7,841	8,344	7,129	9,536	17,281
Provision for income taxes	(344)	564	(234)	608	3,868
Net Income	8,185	7,780	7,363	8,928	13,413
Balance Sheet Summary					
Total loans, net	867,078	740,929	783,601	859,875	929,629
Allowance for loan losses	(13,873)	(17,283)	(21,138)	(23,715)	(15,094)
Securities available for sale	380,188	406,471	331,730	278,168	243,413
Cash and due from banks	61,818	63,036	42,435	66,234	46,010
Federal funds sold	-	-	210	-	5,500
Foreclosed Assets	19,754	15,364	20,691	25,654	7,127
Premises and equipment, net	21,830	20,721	20,190	20,069	19,280
Total Interest-Earning assets	1,279,932	1,185,647	1,137,805	1,194,700	1,200,603
Total Assets	1,437,903	1,335,405	1,286,571	1,335,549	1,326,292
Total Interest-Bearing liabilities	895,434	852,308	860,944	953,156	974,177
Total Deposits	1,174,034	1,086,268	1,052,274	1,125,432	1,061,498
Total Liabilities	1,264,011	1,166,841	1,126,974	1,201,069	1,219,492
Total Shareholders' Equity	173,892	168,564	159,597	134,480	106,800
Per Share Data					
Net Income Per Basic Share	0.58	0.55	0.61	0.86	1.40
Net Income Per Diluted Share	0.58	0.55	0.60	0.86	1.37
Book Value	12.33	11.95	11.42	11.57	11.04
Cash Dividends	0.24	0.24	0.24	0.40	0.68
Weighted Average Common Shares Outstanding Basic	14,103,805	14,036,667	12,109,717	10,343,502	9,607,184
Weighted Average Common Shares Outstanding Diluted	14,120,313	14,085,201	12,192,345	10,415,084	9,779,657
Key Operating Ratios:					
Performance Ratios:					
Return on Average Equity [(1)]	4.74 %	4.73 %	5.16 %	7.56 %	12.86 %
Return on Average Assets [(2)]	0.59 %	0.59 %	0.56 %	0.68 %	1.05 %
Net Interest Spread (tax-equivalent) [(3)]	4.08 %	4.41 %	4.72 %	4.74 %	4.52 %

Net Interest Margin (tax-equivalent)	4.22	%	4.58	%	4.89	%	5.00	%	4.98	%
Dividend Payout Ratio [4]	41.35	%	43.29	%	39.86	%	46.76	%	48.73	%
Equity to Assets Ratio [5]	12.51	%	12.37	%	10.82	%	9.03	%	8.12	%
Efficiency Ratio (tax-equivalent)	66.81	%	67.83	%	67.25	%	57.69	%	48.73	%
Net Loans to Total Deposits at Period End	73.85	%	68.21	%	74.47	%	76.40	%	87.58	%
Asset Quality Ratios:										
Non-Performing Loans to Total Loans	6.03	%	7.41	%	5.71	%	5.31	%	3.15	%
Non-Performing Assets to Total Loans and										
Other Real Estate Owned	8.10	%	9.25	%	8.08	%	7.98	%	3.87	%
Net Charge-offs (recoveries) to Average Loans	2.23	%	2.06	%	2.26	%	1.40	%	1.79	%
Allowance for Loan Losses to										
Net Loans at Period End	1.60	%	2.33	%	2.70	%	2.76	%	1.62	%
Allowance for Loan Losses to Non-Performing Loans	26.13	%	30.80	%	46.00	%	50.49	%	50.67	%
Capital Ratios:										
Tier 1 Capital to Adjusted Total Assets	13.34	%	14.11	%	13.84	%	11.91	%	9.92	%
Tier 1 Capital to Total Risk-weighted Assets	18.11	%	20.46	%	19.06	%	15.41	%	12.34	%
Total Capital to Total Risk-weighted Assets	19.36	%	21.72	%	20.33	%	16.67	%	13.59	%

[1] Net income divided by average shareholders' equity.

[2] Net income divided by average total assets.

[3] Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

[4] Total dividends paid divided by net income.

[5] Average equity divided by average total assets.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion presents Management's analysis of the financial condition of the Company as of December 31, 2012 and December 31, 2011, and the results of operations for each of the years in the three-year period ended December 31, 2012. The discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the Notes related thereto presented elsewhere in this Form 10-K Annual Report (see Item 8 below).

Statements contained in this report or incorporated by reference that are not purely historical are forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 as amended, including the Company's expectations, intentions, beliefs, or strategies regarding the future. All forward-looking statements concerning economic conditions, growth rates, income, expenses, or other values which are included in this document are based on information available to the Company on the date noted, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could materially differ from those in such forward-looking statements. Risk factors that could cause actual results to differ materially from those in forward-looking statements include but are not limited to those outlined previously in Item 1A.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan and lease losses, as explained in detail in Note 2 to the consolidated financial statements and in the "Provision for Loan Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 2 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on the fair value of the Company and for which it has been determined that no impairment exists, as discussed in Note 2 to the consolidated financial statements and in the "Other Assets" section of this discussion and analysis; and equity-based compensation, which is discussed in greater detail in Note 2 to the consolidated financial statements contained herein. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.

Summary of Performance

Recessionary conditions have led to relatively high credit costs, diminished lending activity, and associated earnings pressures at the Company for the past five years. There are signs of recovery in the national economy and in certain regions of California, including Kern County, but economic conditions have not yet materially improved in Tulare, Fresno, and Kings Counties. Industry-wide regulatory pressures on certain components of non-interest income have exacerbated the negative impact of the faltering economy on our financial performance in recent years. The Company recognized net income of $8.185 million in 2012 relative to $7.780 million in 2011 and $7.363 million in 2010, representing year-over-year increases in net income for both 2012 and 2011 but still coming in well below levels achieved in pre-recession years. Net income per diluted share was $0.58 for 2012, as compared to $0.55 for 2011 and $0.60 in 2010. The Company's return on average assets and return on average equity were 0.59% and 4.74%, respectively, in 2012, as compared to 0.59% and 4.73%, respectively, for 2011, and 0.56% and 5.16%, respectively, in 2010.

The following are some of the major factors impacting the Company’s results of operations for the years presented in the consolidated financial statements:

- **Net interest income has been declining, falling by 4% in 2012 relative to 2011 and by 6% in 2011 relative to 2010, due to net interest margin compression.** Negative factors affecting the Company’s net interest margin in recent years include relatively strong growth in lower-yielding investment balances (although that trend began to reverse in the second half of 2012), a higher level of non-accruing loans and other non-earning assets, a shift from higher yielding loan categories to lower-yielding loan types, and lower loan yields across the board resulting from increased competition for quality loans.

- **Our loan loss provisions, which have been much higher than in pre-recession years, totaled $14.210 million in 2012, $12.000 million in 2011, and $16.680 million in 2010.** The elevated loan loss provisions have been utilized to establish specific reserves for impaired loans that have migrated into impaired status, replenish reserves subsequent to loan charge-offs, and build general reserves for performing loans due to higher historical loss factors.

- **Non-interest income increased by $3.134 million, or 21%, in 2012 over 2011, but declined by $4.273 million, or 22%, in 2011 relative to 2010.** Significant fluctuations in non-interest income in 2012 were created by non-recurring adjustments that lowered costs associated with tax credit investments and thus boosted income, an increase in bank-owned life insurance (BOLI) income associated with deferred compensation plans, an increase in debit card interchange fees, and the fact that we recorded an impairment charge on equity investment securities in 2011 that wasn’t repeated in 2012. The drop in 2011 relative to 2010 was also impacted by the other-than-temporary impairment charge, as well as a sizeable decrease in overdraft fee income, a decline in BOLI income associated with deferred compensation plans, and a lower level of gains on the sale of investments. Gains on the sale of investment securities totaled $1.762 million in 2012, $1.660 million in 2011, and $2.643 million in 2010.

- **Operating expense, while reflecting favorable trends in 2012 and 2011, has been elevated relative to pre-recession years due in large part to net OREO costs and other credit-related expenses.** The drop of $949,000, or 2%, in total operating expense in 2012 is due in large part to declining credit costs (including net foreclosed asset costs and lending-related legal expense), lower occupancy costs and lower marketing expense. The decline of $4.033 million, or 8%, in 2011 was due mainly to a reduced level of OREO write-downs and OREO operating expense, as well as lower FDIC assessments.

- **The Company had a tax benefit of $344,000 in 2012, a tax provision of $564,000 in 2011, and a tax benefit of $234,000 in 2010.** The tax benefits in 2012 and 2010 were primarily the result of lower taxable income relative to the Company’s available tax credits, and a higher level of tax-exempt BOLI income.

The Company’s assets totaled $1.438 billion at December 31, 2012, relative to total assets of $1.335 billion at December 31, 2011. Total liabilities were $1.264 billion at the end of 2012 compared to $1.167 billion at the end of 2011, and we had shareholders’ equity totaling $174 million at December 31, 2012 relative to $169 million at December 31, 2011. The following summarizes key balance sheet changes during 2012:

- **Total assets increased by $102 million, or 8%.** Investment securities, cash, and balances due from banks declined by a combined $28 million, or 6%, but that drop was more than offset by an increase of $126 million, or 17%, in net loan balances. Our loan growth in 2012 came primarily from the expansion of mortgage warehouse lending and growth in agricultural loans (both ag production and ag real estate loans). The balance of foreclosed assets was also up by $4 million for the year.

- **Nonperforming assets ended 2012 with a balance of $73 million, an increase of $1 million, or 2%, for the year but still below the peak balance of $80 million reported at September 30, 2009.** The net increase for the year is comprised of the $4 million increase in foreclosed assets noted above, partially offset by a $3 million net reduction in loans on non-accrual status. We had been making significant progress in reducing the balance of nonperforming loans for most of 2012, but much of that improvement was reversed in the fourth quarter subsequent to the downgrade to non-accrual status of two large loan relationships totaling approximately $28 million. The Company's ratio of nonperforming assets to loans plus foreclosed assets fell to 8.10% at December 31, 2012 from 9.25% at December 31, 2011, due to the increase in gross loan balances.

- **Our allowance for loan and lease losses was $13.9 million as of December 31, 2012, a decline of $3.4 million, or 20%, relative to year-end 2011.** The drop during 2012 was due in part to certain loan charge-offs which were taken against previously-established specific reserves and thus did not require replenishment, as well as a reduction in general reserves consistent with improvement in the quality of the Company's performing loans. Due to the decline in the overall allowance and the increase in total loans, the allowance fell to 1.58% of total loans at December 31, 2012 from 2.28% at December 31, 2011. Pursuant to management's detailed analysis, the allowance as of the end of 2012 is expected to be sufficient to cover specifically identified probable losses on impaired loans and leases, as well as probable incurred losses inherent in the remaining loan portfolio.

- **Total deposits increased by $88 million, or 8%, during 2012.** Non-maturity deposits were up $100 million, or 14%, including significant increases in savings deposits, non-interest bearing demand deposits, and interest-bearing transaction accounts due in part to aggressive deposit acquisition programs and an intensified focus on business relationships. A drop in time deposits partially offset the increase in non-maturity deposits.

- **Total capital was $174 million at December 31, 2012, reflecting an increase of $5 million, or 3%, for the year.** Risk-based capital ratios declined, however, as capital was leveraged for organic loan growth. At December 31, 2012, the consolidated Company's Total Risk-Based Capital Ratio was 19.36%, its Tier One Risk-Based Capital Ratio was 18.11%, and its Tier One Leverage Ratio was 13.34%.

Results of Operations

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

Net interest income was $50.581 million in 2012, compared to $52.957 million in 2011 and $56.182 million in 2010. This represents declines of 4% in 2012 and 6% in 2011. The level of net interest income depends on several factors in combination, including but not necessarily limited to growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the volume of earning assets relative to interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

The following Distribution, Rate and Yield table shows, for each of the past three years, the average balance of each significant balance sheet category and the amount of interest income or interest expense associated with each applicable category. The table also displays the calculated yields on each major component of the Company's investment and loan portfolios, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin.

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Distribution, Rate & Yield	Year Ended December 31,							
(dollars in thousands, except per share data)	2012			2011			2010	
	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Inc Ex
Assets								
Investments:								
Federal funds sold/Due from time	$26,558	$70	0.26%	$25,930	$68	0.26%	$14,066	$4
Taxable	335,553	6,280	1.87%	319,635	8,732	2.73%	239,926	8
Non-taxable	77,646	2,703	5.36%	73,108	2,834	5.96%	68,858	2
Equity	1,755	84	4.79%	1,508	21	1.39%	1,473	9
Total Investments	441,512	9,137	2.40%	420,181	11,655	3.14%	324,323	1
Loans and Leases:[3]								
Agricultural	17,231	760	4.41%	13,847	648	4.68%	10,137	5
Commercial	171,344	9,157	5.34%	104,293	6,224	5.97%	115,188	6
Real Estate	525,594	32,981	6.27%	553,063	35,970	6.50%	612,001	4
Consumer	30,307	2,638	8.70%	39,928	3,731	9.34%	50,522	4
Direct Financing Leases	4,233	229	5.41%	6,723	386	5.74%	10,835	6
Other	40,624	-	0.00%	50,047	-	0.00%	52,609	-
Total Loans and Leases	789,333	45,765	5.80%	767,901	46,959	6.12%	851,292	5
Total Interest Earning Assets[4]	1,230,845	54,902	4.57%	1,188,082	58,614	5.06%	1,175,615	6
Other Earning Assets	6,579			7,735			8,984	
Non-Earning Assets	142,887			133,733			134,552	
Total Assets	$1,380,311			$1,329,550			$1,319,151	
Liabilities and Shareholders' Equity								
Interest Bearing Deposits:								
Demand Deposits	$69,281	$257	0.37%	$24,707	$137	0.55%	$-	$-
NOW	194,249	556	0.29%	179,253	860	0.48%	178,345	1
Savings Accounts	107,672	241	0.22%	85,568	203	0.24%	70,367	1
Money Market	78,775	127	0.16%	132,208	506	0.38%	162,619	9
CDAR's	17,999	52	0.29%	36,335	199	0.55%	70,661	6
Certificates of Deposit<$100,000	106,403	619	0.58%	142,753	1,001	0.70%	162,418	1
Certificates of Deposit≥$100,000	223,611	1,154	0.52%	204,185	1,223	0.60%	194,220	1
Brokered Deposits	15,000	202	1.35%	12,986	176	1.36%	10,885	2
Total Interest Bearing Deposits	812,990	3,208	0.39%	817,995	4,305	0.53%	849,515	6
Borrowed Funds:								
Federal Funds Purchased	-	-	-	4	-	0.19%	3	-
Repurchase Agreements	3,441	21	0.61%	2,371	16	0.67%	-	-
Short Term Borrowings	15,234	37	0.24%	5,637	39	0.69%	16,044	1
Long Term Borrowings	6,967	281	4.03%	15,000	569	3.79%	16,041	6
TRUPS	30,928	774	2.50%	30,928	728	2.35%	30,928	7
Total Borrowed Funds	56,570	1,113	1.97%	53,940	1,352	2.51%	63,016	1
Total Interest Bearing Liabilities	869,560	4,321	0.50%	871,935	5,657	0.65%	912,531	7
Non-interest Bearing Demand Deposits	319,501			276,363			246,949	
Other Liabilities	18,551			16,744			16,917	
Shareholders' Equity	172,699			164,508			142,754	
Total Liabilities and Shareholders' Equity	$1,380,311			$1,329,550			$1,319,151	

Interest Income/Interest Earning Assets		4.57%		5.06%	
Interest Expense/Interest Earning Assets		0.35%		0.48%	
Net Interest Income and Margin[5]	$50,581	4.22%	$52,957	4.58%	$5

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2) Yields and net interest margin have been computed on a tax equivalent basis.

(3) Loans are gross of the allowance for possible loan losses. Net loan fees have been included in the calculation of interest income. Net loan Fees were $5,476, $(635,719) and $(491,045) for the years ended December 31, 2012, 2011, and 2010 respectively.

(4) Non-accrual loans have been included in total loans for purposes of total interest earning assets.

(5) Net interest margin represents net interest income as a percentage of average interest-earning assets (tax-equivalent).

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The Volume and Rate Variances table below sets forth the dollar difference in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities for the comparative periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in average balance multiplied by prior period rates, and rate variances are equal to the increase or decrease in rate times prior period average balances. Variances attributable to both rate and volume changes are calculated by multiplying the change in rate by the change in average balance, and have been allocated to the rate variance.

Volume & Rate Variances	Years Ended December 31,					
(dollars in thousands)	2012 over 2011			2011 over 2010		
	Increase(decrease) due to			Increase(decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
Assets:						
Investments:						
Federal funds sold / Due from time	$2	$0	$2	$34	$(6)	$28
Taxable	435	(2,887)	(2,452)	2,663	(1,947)	716
Non-taxable(1)	176	(307)	(131)	167	(42)	125
Equity	3	60	63	0	12	12
Total Investments	616	(3,134)	(2,518)	2,864	(1,983)	881
Loans and Leases:						
Agricultural	158	(46)	112	189	(58)	131
Commercial	4,001	(1,068)	2,933	(651)	(7)	(658)
Real Estate	(1,787)	(1,202)	(2,989)	(3,917)	(782)	(4,699)
Consumer	(899)	(194)	(1,093)	(918)	272	(646)
Direct Financing Leases	(143)	(14)	(157)	(232)	6	(226)
Other	-	-	-	-	-	-
Total Loans and Leases	1,330	(2,524)	(1,194)	(5,529)	(569)	(6,098)
Total Interest Earning Assets	$1,946	$(5,658)	$(3,712)	$(2,665)	$(2,552)	$(5,217)
Liabilities						
Interest Bearing Deposits:						
Demand	$247	$(127)	$120	$-	$137	$137
NOW	72	(376)	(304)	9	(831)	(822)
Savings Accounts	52	(14)	38	38	(9)	29
Money Market	(205)	(174)	(379)	(171)	(237)	(408)
CDAR's	(100)	(47)	(147)	(302)	(120)	(422)
Certificates of Deposit < $100,000	(255)	(127)	(382)	(155)	(127)	(282)
Certificates of Deposit ≥ $100,000	116	(185)	(69)	63	(77)	(14)
Brokered Deposits	27	(1)	26	41	(75)	(34)
Total Interest Bearing Deposits	(46)	(1,051)	(1,097)	(477)	(1,339)	(1,816)
Borrowed Funds:						
Federal Funds Purchased	-	-	-	-	-	-
Repurchase Agreements	7	(2)	5	-	16	16
Short Term Borrowings	66	(68)	(2)	(123)	(28)	(151)
Long Term Borrowings	(305)	17	(288)	(39)	4	(35)

TRUPS	-	46	46	-	(6)	(6)
Total Borrowed Funds	(232)	(7)	(239)	(162)	(14)	(176)
Total Interest Bearing Liabilities	(278)	(1,058)	(1,336)	(639)	(1,353)	(1,992)
Net Interest Income	$2,224	$(4,600)	$(2,376)	$(2,026)	$(1,199)	$(3,225)

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

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As shown above, the Company had a favorable volume variance of $2.224 million in net interest income for 2012 relative to 2011. The variance was due primarily to growth of $43 million in average interest-earning assets, but the benefit provided by growth in average interest-earning assets was muted to some extent by the fact that the growth was split between loans and lower-yielding investments. Furthermore, loan growth was generally concentrated in lower-yielding agricultural and commercial loans, while higher-yielding real estate loans and consumer loans declined. It should also be noted that our loan growth in 2012 occurred primarily in the latter half of the year, so the growth is not fully reflected in annual average balances. Strong growth in the average balances of low-cost non-maturity deposits and equity helped compensate for some of the unfavorable pressures on the volume variance. Also favorably impacting the volume variance was a $9 million reduction in the average balance of nonperforming loans.

In contrast to the favorable volume variance for 2012 over 2011, the impact of interest rate changes led to an unfavorable rate variance of $4.600 million in net interest income. Our weighted average yield on interest-earning assets was 49 basis points lower in 2012, reflecting a 74 basis point decline in our yield on investments and a 32 basis point drop in the weighted average yield on loans. The lower investment yield is due to the addition of investment securities and the reinvestment of cash from prepayments and maturing balances in a historically low rate environment. Lower loan yields resulted from growth in lower-yielding loan categories and runoff in higher-yielding categories, as well as a general decline in loan interest rates due to intense competition for quality loans. By comparison, our weighted average cost of interest-bearing liabilities was just 15 basis points lower, with the drop due primarily to the lack of competitive pressures on deposit rates and an improving deposit mix. The negative rate variance is exacerbated by our sizeable net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. Our average net interest position in 2011, which is the base period for the rate variance calculation, was $316 million, meaning that the yield decrease for interest-earning assets was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income. Also contributing to the negative pressures on our rate variance was an increase in net interest reversals on loans placed on non-accrual status; we had $276,000 in net interest reversals in 2012, relative to $189,000 in 2011.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.22% in 2012, a decline of 36 basis points relative to 2011. The principal negative factors impacting the Company's net interest margin in 2012 include relatively strong growth in lower-yielding investment balances in the first half of the year (although that trend began to reverse in the second half), a shift from higher yielding loan categories to lower-yielding loan types, lower loan yields across the board resulting from increased competition for quality loans, and an increase in net interest reversals. However, those negatives were partially offset by a relatively large increase in the average balance of non-interest bearing demand deposits, a shift in average interest-bearing deposit balances from higher-cost deposits into lower-cost deposit categories, and a drop in certain deposit rates.

Net interest income declined in 2011 relative to 2010 due to a drop of 32 basis points in our net interest margin, with the margin decline partially offset by a $12 million increase in average interest-earning assets. The principle negative factors impacting our net interest margin in 2011 were a shift from average loan balances into lower-yielding investment balances, and lower loan yields resulting from increased competition for quality loans. Having a favorable

effect on our net interest margin were a shift in average liability balances from higher-cost deposits and borrowings into lower-cost non-maturity deposits, a reduced reliance on interest-bearing liabilities, and a drop in average non-accruing loan balances.

Provision for Loan and Lease Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as the provision for loan and lease losses. The severity of economic challenges has contributed to higher loan loss provisions for the past several years than in prior periods of strong economic growth, due to the negative impact of recessionary conditions on many of our borrowers and the resulting credit challenges in our loan portfolio. The Company’s loan loss provision totaled $14.210 million in 2012, $12.000 million in 2011, and $16.680 million in 2010. The provision was increased by $2.210 million, or 18%, in 2012 relative to 2011, but reflects a decrease of $4.680 million, or 28% for 2011 relative to 2010. These elevated loan loss provisions have been utilized to establish specific reserves for impaired loans that have migrated into impaired status, enhance specific reserves on other impaired collateral-dependent loans that might have experienced deterioration in the value of their underlying collateral, replenish reserves subsequent to loan charge-offs, and build general reserves for performing loans due to higher historical loss factors.

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The Company’s loan loss provisions have been sufficient to maintain an allowance for loan and lease losses at a level that, in management’s judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans, as well as probable incurred losses in the remaining loan portfolio. When available information confirms that specific loans and leases, or portions thereof, are uncollectible, those amounts are immediately charged off against the allowance. Net loans charged off in 2012 totaled $17.620 million, relative to $15.855 million in 2011 and $19.257 million in 2010. The Company’s loan loss provision was lower than loan charge-offs for all three years, since many of the charge-offs were taken against previously-established specific reserves and did not directly result in the need for reserve replenishment via the loan loss provision. The level of charge-offs also affects historical loss factors used in calculating general reserves for non-impaired loans, and higher loss factors can lead to a larger loan loss provision if it is determined that general reserves require enhancement. While this occurred to some extent in 2012, the impact was partially offset by the adjustment of qualitative factors pursuant to management’s determination that credit risk in non-impaired loans has declined, as discussed in further detail below under “Allowance for Loan and Lease Losses.”

The Company’s policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed below under “Allowance for Loan and Lease Losses.” The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company’s loan loss provision, and consequently in our net earnings.

Non-interest Revenue and Operating Expense

The following table sets forth the major components of the Company's non-interest revenue and operating expense, along with relevant ratios, for the years indicated:

Non-Interest Revenue/Expense

(dollars in thousands)

	Year Ended December 31,								
	2012	% of Total		2011	% of Total		2010	% of Total	
OTHER OPERATING INCOME:									
Service charges on deposit accounts	$9,676	53.38	%	$9,543	63.65	%	$11,212	58.20	%
Credit card fees	390	2.15	%	411	2.74	%	391	2.03	%
Checkcard fees	2,787	15.38	%	2,519	16.80	%	2,261	11.74	%
Other service charges and fees	2,060	11.36	%	1,949	13.00	%	2,129	11.05	%
Bank owned life insurance income	1,420	7.83	%	934	6.23	%	1,382	7.17	%
Gains on sales of loans	183	1.01	%	139	0.93	%	105	0.55	%
Gain on sales investment securities	1,762	9.72	%	1,660	11.07	%	2,643	13.72	%
Other-than-temporary impairment losses on equity securities	-	0.00	%	(1,370)	-9.14	%	-	0.00	%
(Loss) on tax credit investment	(395)	-2.18	%	(885)	-5.90	%	(808)	-4.19	%
Other	243	1.35	%	92	0.62	%	(50)	-0.27	%
Total non-interest income	18,126	100.00	%	14,992	100.00	%	19,265	100.00	%
As a % of average interest-earning assets		1.47	%		1.26	%		1.64	%
OTHER OPERATING EXPENSES:									
Salaries and employee benefits	20,734	44.44	%	20,669	43.42	%	20,869	40.41	%
Occupancy costs									
Furniture and equipment	2,061	4.42	%	2,366	4.97	%	2,406	4.66	%
Premises	4,320	9.26	%	4,392	9.23	%	4,634	8.97	%
Advertising and marketing costs	1,771	3.80	%	2,051	4.31	%	1,979	3.83	%
Data processing costs	1,807	3.87	%	1,523	3.20	%	1,737	3.36	%
Deposit services costs	2,266	4.86	%	2,516	5.29	%	2,708	5.24	%
Loan services costs									
Loan processing	1,035	2.22	%	1,082	2.27	%	765	1.48	%
Foreclosed Assets	4,914	10.53	%	5,226	10.98	%	7,572	14.66	%
Other operating costs									
Telephone and data communications	1,549	3.32	%	1,291	2.71	%	1,156	2.24	%
Postage and mail	718	1.54	%	576	1.21	%	558	1.08	%
Other	765	1.64	%	886	1.86	%	1,059	2.05	%
Professional services costs									

Legal and accounting	1,252	2.68	%	1,719	3.61	%	1,276	2.47	%
Other professional services costs	2,202	4.72	%	2,222	4.67	%	3,742	7.25	%
Stationery and supply costs	738	1.58	%	705	1.48	%	715	1.38	%
Sundry & tellers	524	1.12	%	381	0.79	%	462	0.92	%
Total other operating expense	$46,656	100.00	%	$47,605	100.00	%	$51,638	100.00	%
As a % of average interest-earning assets		3.79	%		4.01	%		4.39	%
Net non-interest income as a % of average interest-earning assets		-2.32	%		-2.75	%		-2.75	%
Efficiency ratio [1]		66.81	%		67.83	%		67.25	%

[1] Tax Equivalent

The overhead efficiency ratio in the table above represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income (total revenue), adjusted to exclude the provision for loan losses, investment gains and losses, and other extraordinary gains and losses from the equation. Adjusted revenue declined slightly in 2012, but adjusted operating expense fell by a proportionately greater amount so our efficiency ratio was 102 basis points lower in 2012 than in 2011. Our efficiency ratio rose by 58 basis points in 2011 compared to 2010, since the drop in revenue was proportionately greater than the drop in operating expense.

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The Company's results reflect an increase in total non-interest income of $3.134 million, or 21%, for 2012 over 2011, but a decline of $4.273 million, or 22%, in 2011 relative to 2010. While the primary reasons for these fluctuations are discussed in greater detail below, several items of a non-recurring nature have impacted non-interest income over the past few years. For 2012, those items include the following: Gains on the sale of investments totaling $1.762 million; accrual adjustments which contributed to a drop of $490,000 in costs associated with tax credit investments and other limited partnership investments, and thus increased income; life insurance proceeds totaling $87,000; and, income on BOLI associated with deferred compensation plans totaling $339,000 in 2012, relative to a net loss of $92,000 on deferred compensation BOLI in 2011. In 2011, non-recurring items include the referenced loss on deferred compensation BOLI, a $1.660 million gain on the sale of investment securities, and a $1.370 million other-than-temporary impairment charge on equity investment securities. In 2010, non-recurring items include $2.643 million in gains on investment securities, and $238,000 in losses incurred upon the disposition of equipment that was acquired subsequent to the termination of operating leases. Total non-interest revenue was 1.47% of average earning assets in 2012, relative to 1.26% in 2011 and 1.64% in 2010.

The principal component of non-interest revenue, namely service charges on deposit accounts, increased by $133,000, or 1%, in 2012 over 2011, since a drop in overdraft and returned item charges was more than offset by increases in other deposit-related income. Deposit service charges declined by $1.669 million, or 15%, in 2011 relative to 2010, due to a drop in returned item and overdraft charges resulting from procedural changes and fee adjustments implemented pursuant to newly-enacted consumer-focused legislation and updated regulatory guidelines. The Company's ratio of service charge income to average transaction account balances was 1.7% in 2012, down from 2.0% in 2011 and 2.6% in 2010.

The next line item under other operating income is credit card fees, which consist primarily of credit card interchange fees. Despite the sale of all credit card balances in 2007, we still receive a portion of the interchange and interest income from credit cards issued in our name. Credit card fees declined by $21,000, or 5%, in 2012 relative to 2011, but increased by $20,000, or 5%, in 2011 over 2010.

Check card fees, which represent interchange fees from electronic funds transactions (EFT), increased by $268,000, or 11%, in 2012 over 2011, and also increased by $258,000, or 11%, in 2011 relative to 2010. The increases resulted from fees earned on incremental cards issued in association with new retail deposit accounts, as well as increased usage per card. The rising popularity of point-of-sale transactions leads us to believe that the upward trend in the number of such transactions will likely continue, although that will not necessarily translate into higher fees since interchange rates could decline.

Other service charges and fees also constitute a relatively large portion of non-interest income, with the principal components consisting of ATM fees from transactions not associated with deposit customers (also referred to as foreign ATM fees), currency order fees, other fees for merchant services, and operating lease income. Other service charges, commissions, and fees increased by $111,000, or 6%, in 2012 over 2011, but declined by $180,000, or 8%, in 2011 relative to 2010. The increase in 2012 came from relatively small increases in numerous categories, while the decline in 2011 was due to a drop in leasing income resulting from declining operating lease balances which was

partially offset by increases in merchant fees and foreign ATM fees.

Bank-owned life insurance income increased by $486,000, or 52%, in 2012 over 2011, but declined by $448,000, or 32%, in 2011 relative to 2010. The fluctuations were primarily the result of income and losses on BOLI associated with deferred compensation plans, which is classified as "separate account" BOLI. The Company owns and derives income from two basic types of BOLI: "general account" and "separate account." At December 31, 2012, the Company had $34.8 million invested in single-premium general account BOLI, which generates income that is used to help offset expenses associated with executive salary continuation plans, director retirement plans and certain other employee benefits. General account BOLI income is typically fairly consistent, with interest credit rates that do not change frequently, although a $5 million additional investment in BOLI at the end of the third quarter of 2011 supplemented our general account BOLI income. In addition to general account BOLI, the Company had $3.2 million invested in separate account BOLI at December 31, 2012, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. Deferred compensation accounts have returns pegged to participant-directed investment allocations, and are thus subject to gains or losses which often contribute to significant fluctuations in income from period to period. There was a gain on separate account BOLI totaling $339,000 in 2012 relative to a loss of $92,000 in 2011, for an absolute increase in separate account BOLI income of $431,000 for the comparative years. The comparison for 2011 relative to 2010 reflects a drop of $444,000 in separate account BOLI income, due to the $92,000 loss in 2011 relative to a gain of $352,000 in 2010. As noted, gains and losses on separate account BOLI are related to participant gains and losses on deferred compensation balances. Participant gains are accounted for as expense accruals which, combined with their associated tax effect, effectively offset income on separate account BOLI, while participant losses result in expense accrual reversals that effectively offset losses on separate account BOLI.

Gains on loan sales increased by $44,000 or 32%, in 2012 over 2011, and also reflect an increase of $34,000, or 32%, in 2011 over 2010. Loan sales have been increasing due to a rise in mortgage lending activity. In 2012, 2011 and 2010, gains on the sale of investments totaled $1.762 million, $1.660 million, and $2.643 million, respectively, representing significant additions to income. The net gain on investments for 2012 was due primarily to gains realized in the fourth quarter, subsequent to the sale of approximately $49 million in mortgage-backed and municipal securities to provide additional liquidity for loan growth. The net gain in 2011 came from the sale of $43 million in select mortgage-backed securities, the proceeds of which were used to retire short-term debt and enable the non-renewal of certain higher-cost time deposits. The sale of securities in both 2012 and 2011 helped us reduce potential volatility and improve the overall quality of the bonds held in our investment portfolio, but contributed to a lower yield on investments. In 2011 we also recorded a $1.370 million other-than-temporary impairment (OTTI) charge against equity investment securities, offsetting much of the income boost provided by the gain on the sale of investments. The investment gains realized in 2010 were taken pursuant to a portfolio restructuring in the third quarter that involved the sale of $64 million in mortgage-backed securities.

The next line item reflects pass-through losses associated with our investments in low-income housing tax credit funds and other limited partnership investments. Those costs, which are netted out of revenue, declined by $490,000, or 55%, in 2012 relative to 2011, but increased by $77,000, or 10%, in 2011 over 2010. Annual fluctuations typically result from expense accrual adjustments made subsequent to the receipt of updated partnership financial statements, and the relatively large drop in 2012 was primarily the result of cumulative accrual adjustments that are not expected to be repeated in future years.

Other non-interest income includes gains and losses on the disposition of assets (other than foreclosed assets), life insurance proceeds, and rental income generated by the Company's alliance with Investment Centers of America (ICA). Other non-interest income improved by $151,000, or 164%, in 2012 over 2011, and also reflects an increase of $142,000 in 2011 relative to 2010. Other income in 2012 includes non-recurring life insurance proceeds totaling $87,000. A non-recurring $238,000 loss on the disposition of equipment acquired upon the termination of operating leases in 2010 was a factor in the comparative results for 2011 over 2010.

Total operating expense (non-interest expense) declined $949,000, or 2%, in 2012 relative to 2011, and was down by $4.033 million, or 8%, in 2011 relative to 2010. The reduction in 2012 resulted from favorable variances in numerous expense categories. The drop in 2011 relative to 2010 was due primarily to a reduced level of net OREO expenses and lower FDIC assessments. Non-interest expense includes the following non-recurring items and expenses related to ongoing credit issues: Net OREO expense of $4.914 million in 2012, $5.226 million in 2011, and $7.572 million in 2010; a $75,000 non-recurring expense offset in 2012 in conjunction with the renewal of our contract for debit transaction processing; vendor credits in the amount of $181,000 received in 2011, for prior-year overcharges on processing software; a non-recurring accrual of $240,000 in 2011 for potential expenses related to leases; and, a $75,000 legal settlement paid in 2010 on an operations-related issue. Total non-interest expense declined to 3.79% of average earning assets for 2012, relative to 4.01% in 2011 and 4.39% in 2010.

The largest component of operating expense, namely salaries and employee benefits, increased by only $65,000, or less than 1%, in 2012 over 2011, and declined by $200,000, or 1%, in 2011 relative to 2010. All three years reflect reduced accruals for officer bonuses to adjust for Company, branch, and individual performance relative to internal targets. Additional components of compensation expense that can experience significant variability and are typically difficult to predict include salaries associated with successful loan originations, which are accounted for in accordance with FASB guidelines on the recognition and measurement of non-refundable fees and origination costs for lending activities, and accruals associated with employee deferred compensation plans. Loan origination salaries that were deferred from current expense for recognition over the life of the related loans totaled $2.745 million in 2012, $2.586 million in 2011, and $2.376 million in 2010, with the fluctuations due to variability in successful loan origination activity. Employee deferred compensation expense accruals totaled $188,000 in 2012, relative to $17,000 in 2011 and $206,000 in 2010. As noted above in our discussion of BOLI income, the accruals associated with employee deferred compensation plans are related to separate account BOLI income and losses, as are directors deferred compensation accruals that are included in "other professional services," and the net income impact of all income/expense accruals related to deferred compensation is usually minimal. Salaries and benefits have been further impacted by normal annual salary adjustments, and strategic staff additions in recent years to help position the Company for future growth opportunities. The increase in deferred compensation expense accruals in 2012 was almost entirely offset by the increase in the deferral of loan origination salaries, thus the slight increase in total salaries and benefits was primarily due to regular annual increases and staff additions. The drop in total compensation expense in 2011 was due to a lower level of deferred compensation accruals and a higher level of deferred loan origination salaries, with those beneficial variances partially offset by an increase in expense accruals associated with stock options. Salaries and benefits increased to 44.44% of total operating expense in 2012, from 43.42% in 2011 and 40.41% in 2010, with the increase in the ratio resulting from a declining level of total operating expense rather than a rising level of salaries and benefits. The number of full-time equivalent staff employed by the Company totaled 399 at the end of 2012, 383 at the end of 2011, and 390 at the end of 2010.

Total rent and occupancy costs, including furniture and equipment expense, dropped by $377,000, or 6%, in 2012 relative to 2011, and also fell by $282,000, or 4%, in 2011 as compared to 2010. The decline in 2012 is due mainly to lower costs resulting from the purchase of our headquarters office building at the end of 2011, and a drop in depreciation expense on furniture and equipment. The largest impact for 2011 came from the January 2011 closure of a branch with a relatively costly lease, and lower maintenance/repair costs.

Advertising and marketing costs declined by $280,000, or 14%, in 2012 relative to 2011, but were up by $72,000, or 4%, in 2011 over 2010. The drop in 2012 was due mainly to a reduction in costs associated with our direct-mail marketing campaign for deposits, as well as lower television and print advertising costs. Management expects marketing costs to increase in 2013, perhaps back to 2011 levels, due to the enhancement of our direct-mail campaign and an increase in image advertising.

Data processing costs reflect an increase of $284,000, or 19%, in 2012 over 2011, but a drop of $214,000, or 12%, in 2011 as compared to 2010. The increase in 2012 was due in large part to $181,000 in non-recurring vendor credits which were received in the first quarter of 2011 for prior-year overcharges on processing software, as well as higher internet banking costs. The decline for 2011 also resulted largely from the referenced vendor credits.

Deposit services costs dropped by $250,000, or 10%, in 2012, and by $192,000, or 7%, in 2011. The decline for 2012 was due in part to a $75,000 non-recurring expense offset in conjunction with the renewal of our contract for debit card transaction processing, as well as lower operating costs associated with online deposit products, debit card processing and other miscellaneous deposit cost categories. The decline for 2011 was due primarily to lower costs associated with our online deposit products, net of an increase in debit card processing costs.

Loan services costs, which include net expenses associated with foreclosed assets, credit card costs, and other loan processing costs, were reduced by $359,000, or 6%, in 2012 relative to 2011, and by $2.029 million, or 24%, in 2011 relative to 2010. Much of the variability in loan costs in recent years has been driven by net expenses on foreclosed assets, which is comprised of write-downs taken subsequent to re-appraisals, OREO operating expense (including property taxes), and losses on the sale of foreclosed assets, net of rental income on OREO properties and gains on the sale of foreclosed assets. Net foreclosed asset expenses have been trending down, due primarily to the fact that OREO write-downs have been declining as real estate values have started to stabilize. For 2011 over 2010, the drop in OREO costs was partially offset by increases in costs associated with collections and appraisals and the aforementioned non-recurring accrual of $240,000 in 2011 for potential expenses on operating leases.

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The “other operating costs” category includes telecommunications expense, postage, and other miscellaneous costs. Telecommunications expense increased by $258,000, or 20%, in 2012, and by $135,000, or 12%, in 2011, due to rate increases as well as costs associated with the addition and enhancement of data circuits. Postage expense increased by $142,000, or 25%, in 2012, and by $18,000, or 3%, in 2011, with the increase in 2012 resulting primarily from additional mailings for compliance disclosures relating to deposit account overdrafts. Other miscellaneous costs fell by $121,000, or 14%, in 2012, and by $173,000, or 16%, in 2011, due to lower depreciation on operating leases and tighter expense controls in various other areas.

Legal and accounting costs declined by $467,000, or 27%, in 2012 relative to 2011, but increased by $443,000, or 35%, in 2011 over 2010. The reduction in 2012 was mainly from lower legal costs for loan collections, while the increase for 2011 was due to higher legal costs for collections and consulting costs which were necessitated by the numerous changes in regulatory expectations and the associated promulgation of new guidance on overdrafts.

Other professional services costs include FDIC assessments and other regulatory costs, directors’ costs, certain insurance costs, and certain shareholder expenses. This category was substantially the same in 2012 as in 2011, since a $215,000 increase in accruals for directors’ deferred compensation was effectively offset by a lower accrual for regulatory assessments. Other professional services costs fell by $1.520 million, or 41%, in 2011 relative to 2010, due in part to a lower accrual for FDIC assessments resulting from the FDIC’s implementation of a new rate structure in 2011 and the Company’s reduced risk profile. The 2011 variance in other professional service expense also reflects a decline in director retirement plan accruals, and a drop in deferred compensation accruals for the Company’s directors due to losses on directors’ deferred compensation plans in 2011 relative to gains in 2010. As with deferred compensation accruals for employees, directors’ deferred fee accruals are related to separate account BOLI income and losses, and the net income impact of all income/expense accruals related to deferred compensation is usually minimal.

Stationery and supply costs increased $33,000, or 5%, in 2012, but declined by $10,000, or 1%, in 2011. Sundry and teller costs increased $143,000, or 38%, in 2012 over 2011, due to a surge in debit card fraud. Our debit card processor implemented additional fraud detection and prevention capabilities in October 2012 which should help reduce losses from levels experienced in 2012, although no assurance can be provided in that regard. Sundry and teller costs fell by $81,000, or 18%, in 2011, due mainly to a non-recurring settlement of $75,000 paid to a deposit customer in 2010 for a fraud loss.

Income Taxes

The Company sets aside its provision for income taxes on a monthly basis. As indicated in Note 9 in the Notes to Consolidated Financial Statements, the amount of such provision is determined by applying the Company’s statutory income tax rates to pre-tax book income as adjusted for permanent differences between book income and taxable income. Those permanent differences include, but are not limited to, tax-exempt interest income, increases in the cash surrender value of BOLI (BOLI income), California Enterprise Zone deductions, and certain book expenses that are

not allowed as tax deductions. Tax-exempt interest income is generated primarily by the Company's investments in state, county and municipal bonds, which provided $2.703 million in federal tax-exempt income in 2012, $2.834 million in 2011, and $2.709 million in 2010. Tax credits, including hiring tax credits as well as those generated by our investments in low-income housing tax credit funds, are applied as a direct reduction to our tax liability for both book and tax purposes. The Company had investments totaling $8.7 million in low-income housing tax credit funds as of December 31, 2012. Those investments, which are included in other assets rather than in our investment portfolio, have generated substantial tax credits over the past few years, with about $1.4 million in credits available for the 2012 tax year and $1.6 million in tax credits utilized in 2011. The credits are dependent upon the occupancy level of the housing projects and income of the tenants, and cannot be projected with complete certainty. Furthermore, our capacity to utilize them will continue to depend on our ability to generate sufficient pre-tax income. Because we have not invested in additional tax credit funds for the past few years, the level of low-income housing tax credits available for future years will taper off until they are substantially utilized by the end of 2018. This means that even if taxable income stayed at the same level through 2018, our tax accrual rate would gradually increase.

The Company had an income tax benefit of $344,000 in 2012, relative to income tax expense of $564,000 in 2011 and an income tax benefit of $234,000 in 2010. The negative income tax provisions for 2012 and 2010 are primarily the result of lower taxable income relative to the Company's available tax credits, but they were also favorably affected by a higher level of BOLI income. As noted above, tax-exempt interest income on municipal securities was not materially different in 2012, 2011, and 2010.

In addition to permanent differences, some income and expense items are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as it reverses. At the end of 2012, the Company had a net deferred tax asset of $12.0 million.

Financial Condition

Total assets of $1.438 billion at the end of 2012 reflect an increase of $102 million, or 8%, for the year, due to growth in loans. In contrast, we experienced loan growth challenges in 2011, 2010, and 2009 as a result of less-than-ideal economic conditions and heightened competition for quality loans. The $122 million increase in gross loans during 2012 was funded in large part by core non-maturity deposits, which were up $100 million for the period. Investment securities experienced growth during much of 2012, but reflect a net reduction by year-end of $26 million, or 6%, due to the fourth quarter sale of approximately $49 million in balances that consisted primarily of mortgage-backed securities.

Even though the regional economy appears to have stabilized, most of our market areas have not improved materially. Some of our borrowers are still experiencing the residual effects of lower consumer spending and economic activity, and our asset quality is still being negatively impacted. Nonperforming assets, including nonperforming loans and foreclosed assets, ended the year at $72.8 million, an increase of $1.4 million, or 2%, relative to year-end 2011. Nonperforming loans had been trending substantially lower for much of the year, but increased in the fourth quarter of 2012 due to the downgrade of two large loan relationships totaling about $28 million. The Company's allowance for loan and lease losses was 1.58% of total loans at December 31, 2012, a drop from the 2.28% ratio at the end of 2011 due to significant growth in total loans, combined with the fact that net loan charge-offs exceeded the loan loss provision by $3.410 million in 2012. Charge-offs were higher than the provision because some of the charge-offs were made against previously established specific reserves and thus did not require replenishment.

We still have a very strong capital position, due in part to our registered direct offering in 2010 and private placement in 2009, and positive net income throughout the recession. Furthermore, our liquidity position has remained strong for the past couple of years due to growth in customer deposits and the runoff of a large volume of wholesale-sourced brokered deposits and other borrowings, in addition to a substantial increase in unpledged investments. Our robust capital position and access to liquidity resources position us well to take advantage of growth opportunities that might arise as the economy improves, although no assurance can be provided in that regard.

Significant changes in the relative size of balance sheet components in 2012 include net loans and leases, which increased to 60% of total assets at the end of 2012 from 55% at the end of 2011, and investment securities, which declined to 26% of total assets at the end of 2012 from 30% at the end of 2011. On the liability side, non-maturity

deposits increased to 70% of total deposits at the end of 2012 from 67% at the end of 2011, while customer time deposits (including CDARS) fell to 29% of total deposits at December 31, 2012 from 32% at December 31, 2011. The major components of the Company's balance sheet are individually analyzed below, along with information on off-balance sheet activities and exposure.

Loan and Lease Portfolio

The Company's loan and lease portfolio represents the single largest portion of invested assets, substantially greater than the investment portfolio or any other asset category, and the quality and diversification of the loan and lease portfolio are important considerations when reviewing the Company's financial condition. The Company is not involved with chemicals or toxins that might have an adverse effect on the environment, thus its primary exposure to environmental legislation is through its lending activities. The Company's lending procedures include steps to identify and monitor this exposure in an effort to avoid any related loss or liability. The Selected Financial Data table in Item 6 above reflects the amount of loans and leases outstanding at December 31st for each year from 2008 through 2012, net of deferred fees and origination costs and the allowance for loan and lease losses. The Loan and Lease Distribution tables that follow set forth by loan type the Company's gross loans and leases outstanding, and the percentage distribution in each category at the dates indicated. The first table provides the loan distribution for the past five years, with a level of detail consistent with 10-K disclosures in previous years. The second table provides the loan distribution as of the two most recent year-ends using the loan categories that have been disclosed in our recent quarterly reports, which include a greater level of detail for real estate loans than is available for the five-year disclosure. The gross balances shown include nonperforming loans by type, but do not reflect any deferred or unamortized loan origination, extension, or commitment fees, or deferred loan origination costs.

Loan and Lease Distribution

(dollars in thousands)	Year Ended December 31,				
	2012	2011	2010	2009	2008
Real Estate:					
Secured by Commercial/Professional Office Properties including construction and development	$303,424	$328,973	$360,517	$421,114	$456,932
Secured by Residential Properties	170,514	188,117	200,156	188,750	189,849
Secured by Farmland	71,851	60,142	61,293	56,654	57,808
Total Real Estate	545,789	577,232	621,966	666,518	704,589
Agricultural	22,482	17,078	13,457	9,865	13,542
Commercial and Industrial	257,896	99,408	94,768	116,835	122,856
Small Business Administration loans	20,523	21,006	18,616	18,626	19,463
Direct Financing Leases	4,233	6,743	10,234	15,394	19,883
Consumer Loans	28,872	36,124	45,585	56,992	65,755
Total Loans and Leases	$879,795	$757,591	$804,626	$884,230	$946,088
Percentage of Total Loans and Leases					
Real Estate:					
Secured by Commercial/Professional Office Properties including construction and development	34.49 %	43.42 %	44.81 %	47.62 %	48.30 %
Secured by Residential Properties	19.38 %	24.83 %	24.88 %	21.35 %	20.07 %
Secured by Farmland	8.17 %	7.94 %	7.62 %	6.41 %	6.11 %
Total Real Estate	62.04 %	76.19 %	77.30 %	75.38 %	74.47 %
Agricultural	2.56 %	2.25 %	1.67 %	1.12 %	1.43 %
Commercial and Industrial	29.31 %	13.12 %	11.79 %	13.21 %	12.99 %
Small Business Administration loans	2.33 %	2.77 %	2.31 %	2.11 %	2.06 %
Direct Financing Leases	0.48 %	0.90 %	1.27 %	1.73 %	2.11 %
Consumer Loans	3.28 %	4.77 %	5.67 %	6.45 %	6.95 %
	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

Loan and Lease Distribution
(dollars in thousands)

	As of December 31,	
	2012	2011
Real Estate:		
1-4 family residential construction	$3,174	$8,488
Other Construction/Land	28,002	40,060
1-4 family - closed-end	99,917	104,953
Equity Lines	61,463	66,497
Multi-family residential	5,960	8,179
Commercial RE- owner occupied	182,614	183,070
Commercial RE- non-owner occupied	92,808	105,843
Farmland	71,851	60,142
Total Real Estate	545,789	577,232
Agricultural products	22,482	17,078
Commercial and Industrial	257,896	99,408
Small Business Administration Loans	20,523	21,006
Direct finance leases	4,233	6,743
Consumer loans	28,872	36,124
Total Loans and Leases	$879,795	$757,591
Percentage of Total Loans and Leases		
Real Estate:		
1-4 family residential construction	0.35 %	1.12 %
Other Construction/land	3.18 %	5.29 %
1-4 family - closed-end	11.36 %	13.85 %
Equity Lines	6.99 %	8.78 %
Multi-family residential	0.68 %	1.08 %
Commercial RE- owner occupied	20.76 %	24.16 %
Commercial RE- non-owner occupied	10.55 %	13.97 %
Farmland	8.17 %	7.94 %
Total Real Estate	62.04 %	76.19 %
Agricultural products	2.56 %	2.25 %
Commercial and Industrial	29.31 %	13.12 %
Small Business Administration Loans	2.33 %	2.77 %
Direct finance leases	0.48 %	0.90 %
Consumer loans	3.28 %	4.77 %
	100.00 %	100.00 %

The Company's gross loans and leases totaled $880 million at the end of 2012, an increase of $122 million, or 16%, since the end of 2011. Loan balances had been declining for the past few years due to reductions associated with the resolution of impaired loans and runoff in the normal course of business, but they experienced a significant increase in 2012 due in large measure to growth in balances outstanding on mortgage warehouse lines (a subcomponent of commercial and industrial loans). While the Company has engaged in mortgage warehouse lending on a limited basis for the past several years, the surge in balances in 2012 is primarily the result of hiring an experienced mortgage warehouse lender with contacts throughout California, our implementation of new software to automate the process and provide additional internal controls, and recent market opportunities created by an increase in refinancing activity and the decision of certain competitors to focus principally on larger mortgage lenders. Since mortgage lending

activity is strongly correlated to interest rates and has historically been subject to significant fluctuations, no assurance can be provided with regard to our ability to maintain or continue to grow mortgage warehouse balances in the future.

During 2012, commercial loans grew by $158 million, or 159%, increasing to 29.31% of total loans at December 31, 2012 from 13.12% at December 31, 2011. Mortgage warehouse lines account for $142 million of the growth in commercial loans, with net growth of about $16 million in other commercial loan categories. Furthermore, loans secured by farmland (ag mortgage loans) were up almost $12 million, or 20%, and agricultural production loans increased by $5 million, or 32%. The growth in ag mortgage loans was offset by declining balances in other real-estate loan categories, thus total real-estate secured loans declined by $31 million, or 5%, during 2012. Consumer loans were also down $7 million, or 20%, and direct finance leases fell by almost $3 million, or 37%. Management has made selective personnel changes over the past few years and has established branch objectives weighted toward high-quality loan growth, to help ensure that growth is not concentrated solely in one segment of the portfolio and to counter factors that have impeded the Company’s loan growth, such as weak loan demand, tightened credit criteria for real estate loans, and heightened competition. Furthermore, there is anecdotal evidence that certain sectors of the local economy are beginning to improve, which could also benefit loan growth. We have seen a recent increase in lending activity in areas other than mortgage warehouse loans, but no assurance can be provided that this will be sustained and that loan growth will continue, especially in the near term.

Although not reflected in the loan totals above and not currently comprising a material segment of our lending activities, the Company occasionally originates and sells or participates out portions of certain commercial real estate loans, agricultural or residential mortgage loans, and other loans to non-affiliated investors, and we currently provide servicing for a small number of SBA loans.

Loan and Lease Maturities

The following table shows the maturity distribution for total loans and leases outstanding as of December 31, 2012, including non-accruing loans, grouped by remaining scheduled principal payments.

Loans and Lease Maturity

(dollars in thousands)

	As of December 31, 2012						
	Three months or less	Three months to twelve months	One to five years	Over five years	Total	Floating rate: due after one year	Fixed rate: due after one year
Agricultural	$1,519	$ 15,998	$ 3,362	$1,603	$22,482	$1,985	$ 2,980
Commercial and Industrial [1]	182,242	30,889	32,523	32,765	278,419	18,848	46,440
Real Estate	18,071	39,081	102,496	386,141	545,789	209,082	279,555
Consumer Loans	2,338	3,548	7,792	15,194	28,872	1,335	21,651

Direct Financing Leases	843	231	781	2,378	4,233	-	3,159
Total	$205,013	$ 89,747	$ 146,954	$438,081	$879,795	$231,250	$353,785

(1) Includes Small Business and Administration Loans

For a comprehensive discussion of the Company's liquidity position, balance sheet re-pricing characteristics, and sensitivity to interest rates changes, refer to the "Liquidity and Market Risk" section of this discussion and analysis.

Off-Balance Sheet Arrangements

The Company makes commitments to extend credit to its customers in the normal course of business, as long as there are no violations of conditions established in contractual arrangements. The effect on the Company's revenues, expenses, cash flows and liquidity from unused portions of commitments to provide credit cannot be reasonably predicted, because there is no certainty that lines of credit will ever be fully utilized. Total unused commitments to extend credit were $225 million at December 31, 2012, as compared to $154 million at December 31, 2011. Those numbers include $29 million in home equity lines of credit at December 31, 2012, and $31 million at December 31, 2011. The increase in unused commitments during 2012 was due to an increase in undisbursed commitments on mortgage warehouse lines, and the addition of the unused portions of deposit account overdraft lines that were formalized during 2012. Unused commitments represented 26% of gross loans and leases outstanding at December 31, 2012 and 20% at December 31, 2011. In addition to unused loan commitments, the Company had undrawn letters of credit totaling $15 million at December 31, 2012 and $20 million at December 31, 2011.

These off-balance sheet obligations represent potential credit risk to the Company, and a $197,000 reserve for unfunded commitments is reflected as a liability in our consolidated balance sheet at December 31, 2012. For more information regarding the Company's off-balance sheet arrangements, see Note 11 to the consolidated financial statements in Item 8 herein.

Contractual Obligations

At the end of 2012, the Company had contractual obligations for the following payments, by type and period due:

Contractual Obligations
(dollars in thousands)

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Long-term debt obligations	$35,928	$ 5,000	$ -	$ -	$ 30,928
Operating lease obligations	9,054	1,005	1,848	1,384	4,817
Other long-term obligations	962	-	-	-	962
Total	$45,944	$ 6,005	$ 1,848	$ 1,384	$ 36,707

Nonperforming Assets

Nonperforming assets (NPA's) are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and other real estate owned (OREO). OREO consists of properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt exists with regard to the Company's ability to collect all principal and interest on a loan or lease. At that point, we stop accruing interest on the loan or lease in question, and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for a period of 90 days or more is also placed on non-accrual status, even if interest is still being received, unless the asset is both well-secured and in the process of collection. If the Bank grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring (TDR). TDR's may be classified as either nonperforming or performing loans depending on their accrual status.

The tables that follow present comparative data for the Company's nonperforming assets and performing TDR's. The first table provides those numbers for the past five years, with a level of detail consistent with 10-K disclosures in previous years. The second table provides nonperforming assets as of the two most recent year-ends using the loan categories that have been disclosed in our recent quarterly reports, which include a greater level of detail for nonperforming real estate loans than is available for the five-year disclosure.

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Nonperforming Assets and Performing TDRs

(dollars in thousands)	As of December 31,				
	2012	2011	2010	2009	2008
NON-ACCRUAL LOANS:					
Real Estate					
Secured by Commercial/Professional Office Properties including construction and development	$28,120	$25,127	$32,222	$31,842	$24,432
Secured by Residential Properties	16,559	14,099	6,270	5,652	2,918
Secured by Farmland	1,933	6,919	404	429	42
Subtotal Real Estate	46,612	46,145	38,896	37,923	27,392
Agricultural	664	-	-	-	-
Commercial and Industrial	2,386	3,778	2,005	3,559	771
Small Business Administration Loans	2,159	3,452	3,440	3,683	862
Consumer Loans	1,138	2,144	1,112	756	392
Direct Financing Leases	135	591	501	1,053	369
TOTAL NONPERFORMING LOANS	53,094	56,110	45,954	46,974	29,786
Foreclosed assets	19,754	15,364	20,691	25,654	7,127
Total nonperforming assets	$72,848	$71,474	$66,645	$72,628	$36,913
Performing TDRs [1]	$18,652	$36,058	$12,465	$28,024	$-
Nonperforming loans as a % of total gross loans and leases	6.03 %	7.41 %	5.71 %	5.31 %	3.15 %
Nonperforming assets as a % of total gross loans and leases and foreclosed assets	8.10 %	9.25 %	8.08 %	7.98 %	3.87 %

[1] Performing TDRs are not included in nonperforming loans above, nor are they included in the numerators used to calculate the ratios disclosed in this table.

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Nonperforming Assets and Performing TDRs

(dollars in thousands)

	As of December 31,	
	2012	2011
NON-ACCRUAL LOANS: [1]		
Real Estate:		
1-4 family residential construction	$153	$2,244
Other Construction/Land	11,163	4,083
1-4 family - closed-end	15,381	7,605
Equity Lines	1,026	1,309
Multi-family residential	-	2,941
Commercial RE- owner occupied	5,314	7,086
Commercial RE- non-owner occupied	11,642	13,958
Farmland	1,933	6,919
TOTAL REAL ESTATE	46,612	46,145
Agricultural products	664	-
Commercial and Industrial	2,386	3,778
Small Business Administration Loans	2,159	3,452
Direct finance leases	135	591
Consumer loans	1,138	2,144
TOTAL NONPERFORMING LOANS	$53,094	$56,110
Foreclosed assets	19,754	15,364
Total nonperforming assets	$72,848	$71,474
Performing TDRs [1]	$18,652	$36,058
Nonperforming loans as a % of total gross loans and leases	6.03 %	7.41 %
Nonperforming assets as a % of total gross loans and leases and foreclosed assets	8.10 %	9.25 %

[1] Performing TDRs are not included in nonperforming loans above, nor are they included in the numerators used to calculate the ratios disclosed in this table.

Nonperforming assets comprised 4% of total loans and leases plus foreclosed assets at the end of 2008, but have escalated since then due to deterioration in economic conditions and the associated negative impact on our borrowers. Total NPA's increased by $1.4 million, or 2%, during 2012, but fell slightly as a percentage of gross loans and leases plus foreclosed assets due to growth in loans. Nonperforming loans declined by $3.0 million, or 5%, but foreclosed assets increased by $4.4 million, or 29%. As noted above, nonperforming loans had been trending substantially lower for much of the year, but increased in the fourth quarter of 2012 due to the addition of two large relationships totaling about $28 million. One of those relationships consists of a $7 million note which the Company is currently negotiating to sell, although no assurance can be provided that a sale will be consummated. The other relationship is comprised of cross-collateralized development loans and loans secured by income properties, which were current per the terms of

the restructured loan agreements as of year-end and which, when viewed in aggregate, are adequately collateralized and guaranteed by a borrower with strong net worth. The relationship was downgraded and placed on non-accrual status to accelerate the reduction of principal, which could ultimately provide management with a higher degree of confidence that all principal and interest due on the loans will eventually be collected, although no assurance can be provided in that regard.

Non-accruing loan balances secured by real estate comprised $46.6 million of total nonperforming loans at December 31, 2012, and reflect a net increase of $467,000, or 1%, during the year. Gross additions to nonperforming real estate loans totaled $43.4 million for 2012, including the aforementioned relationships transferred in the fourth quarter. Partially offsetting the increase created by additional real estate loans being placed on non-accrual status during 2012 were net pay-downs on nonperforming real estate loans of $10.1 million, charge-offs totaling $8.7 million, $22.5 million in transfers to OREO, and the return to accrual status of $1.7 million in balances. Nonperforming commercial and SBA loans declined by a combined $2.7 million, or 37%, during 2012, ending the period at $4.5 million. Gross additions to nonperforming commercial and SBA loans totaled $2.3 million for 2012, but additions were more than offset by net pay-downs of $1.9 million and the charge-off of $2.8 million in nonperforming commercial loan balances. Nonperforming consumer loans, which are largely unsecured, declined by $1.0 million, or 47%, to a total of $1.1 million at December 31, 2012, due primarily to charge-offs during the year.

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The balance of nonperforming loans at December 31, 2012 includes $33.5 million in TDR’s and other loans that were paying as agreed under modified terms or forbearance agreements but were still classified as nonperforming. As shown in the table, we also had $18.7 million in loans classified as performing TDR’s for which we were still accruing interest at December 31, 2012, relative to a balance of $36.1 million at December 31, 2011. Performing TDR’s reflect a reduction of $17.4 million for the year, since approximately $18 million of the loans in the two large relationships placed on non-accrual status in the fourth quarter of 2012 were performing TDR’s prior to being downgraded. Notes 2 and 4 in the Notes to Consolidated Financial Statements provide a more comprehensive disclosure of TDR balances and activity within recent periods.

As noted above, foreclosed assets increased $4.4 million, or 29%, during 2012, due to the migration of $22.5 million in nonperforming real estate loans into OREO, less OREO sold and any write-downs during that period. A few large loans which were foreclosed on during 2012 were also subsequently sold during the year. The balance of foreclosed assets at December 31, 2012 had an aggregate carrying value of $19.8 million, and was comprised of 69 properties classified as OREO and three mobile homes. Much of our OREO at year-end 2012 consisted of vacant lots or land, but there were also nine residential properties totaling $1.5 million and 12 commercial buildings with a combined book balance of $7.3 million. At the end of 2011 foreclosed assets totaled $15.4 million, comprised of 66 properties in OREO and five mobile homes. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value.

An action plan is in place for each of our non-accruing loans and foreclosed assets and they are all being actively managed or marketed. Collection efforts are continuously pursued for all nonperforming loans, but no assurance can be provided that they will be resolved in a timely manner or that nonperforming balances will not increase further.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. It is maintained at a level that is adequate to absorb specifically identified probable losses on impaired loans and leases, as well as probable incurred losses inherent in the remaining loan portfolio. When available information confirms that specific loans and leases, or portions thereof, are uncollectible, those amounts are immediately charged off against the allowance. Recoveries are generally recorded only when cash payments are received subsequent to the charge off. Note 2 in the Notes to Consolidated Financial Statements provides a more comprehensive discussion of the accounting guidance we conform to and the methodology we use to determine an appropriate allowance for loan and lease losses.

At December 31, 2012, our allowance for loan and lease losses was $13.9 million, or 1.58% of gross loans and leases, a 20% decline from the $17.3 million allowance at December 31, 2011 which was 2.28% of gross loans and leases. The Company’s total allowance was 26.13% of nonperforming loans at December 31, 2012, relative to 30.80% at December 31, 2011. The $3.4 million reduction in the allowance in 2012 was due in part to the write-down of certain

impaired collateral-dependent loan balances against previously-established specific reserves, which did not directly lead to the need for reserve replenishment, as well as a reduction in general reserves consistent with improvement in the quality of the Company's performing loans. Despite substantial charge-offs against previously-established specific reserves, reserves for impaired loans declined by only $1.6 million during 2012, since the impact of charge-offs was partially offset by the establishment of specific reserves for loans migrating to impaired status and the enhancement of specific reserves to reflect updated expectations with regard to realizable values. General reserves for incurred losses on performing loans declined by $1.8 million, or 21%, due to the adjustment of qualitative factors to reflect management's assessment that default risk has declined. We believe that default risk is lower because certain higher-risk balances originated prior to the recession have migrated out of performing loans due to payoffs or performance issues, and many of the remaining loans were originated in recent years using more stringent credit criteria and are thus deemed less likely to experience losses. The decline in the allowance for loan and lease losses resulting from the adjustment of qualitative factors was partially offset by the establishment of loss reserves for new loan growth, and the refinement of proxy loss rates which are incorporated into the model when there is insufficient data to utilize the Bank's own historical loan rates. An allowance for potential losses inherent in unused commitments, totaling $197,000 at December 31, 2012, is included in other liabilities.

The table that follows summarizes the activity in the allowance for loan and lease losses for the periods indicated:

Allowance for Loan and Lease Losses
(dollars in thousands)

	As of and for the years ended December 31,				
Balances:	2012	2011	2010	2009	2008
Average gross loans and leases outstanding during period	$789,333	$767,901	$851,292	$926,326	$931,382
Gross loans and leases held for investment	$879,795	$757,591	$804,626	$884,230	$946,088
Allowance for Loan and Lease Losses:					
Balance at beginning of period	$17,283	$21,138	$23,715	$15,094	$12,276
Provision charged to expense	14,210	12,000	16,680	21,574	19,456
Charge-offs					
Real Estate:					
1-4 family residential construction	46	1,389	1,706	536	1,375
Other Construction/Land	1,994	1,807	4,579	2,599	7,453
1-4 Family - closed-end	1,763	795	1,400	1,649	459
Equity Lines	1,234	1,776	596	695	608
Multi-family residential	1,262	-	97	-	-
Commercial RE- owner occupied	2,117	1,306	946	26	66
Commercial RE - non-owner occupied	2,522	3,027	1,358	-	-
Farmland	170	496	27	-	60
TOTAL REAL ESTATE	11,108	10,596	10,709	5,505	10,021
Agricultural products	634	-	-	524	-
Commercial and Industrial	3,517	3,407	4,998	3,508	2,438
Small Business Administration Loans	753	148	293	143	558
Direct Finance Leases	198	82	646	97	255
Consumer Loans	2,568	2,754	3,691	4,622	3,936
Consumer Credit Cards	-	-	-	5	17
Total	18,778	16,987	20,337	14,404	17,225
Recoveries					
Real Estate:					
1-4 family residential construction	7	133	25	270	32
Other Construction/Land	61	38	13	242	-
1-4 Family - closed-end	40	23	41	10	-
Equity Lines	21	4	41	2	3
Multi-family residential	-	-	-	-	-
Commercial RE- owner occupied	104	71	-	-	-
Commercial RE - non-owner occupied	12	148	-	-	-
Farmland	57	1	-	-	-
TOTAL REAL ESTATE	302	418	120	524	35
Agricultural products	-	-	-	-	-
Commercial and Industrial	483	323	462	474	82
Small Business Administration Loans	95	71	63	75	154

Direct Finance Leases	-	57	159	103	38
Consumer Loans	276	263	274	262	255
Consumer Credit Cards	2	-	2	13	23
Total	1,158	1,132	1,080	1,451	587
Net loan charge offs (recoveries)	17,620	15,855	19,257	12,953	16,638
Balance	$13,873	$17,283	$21,138	$23,715	$15,094

RATIOS					
Net Loan and Lease Charge-offs to Average Loans and Leases	2.23 %	2.06 %	2.26 %	1.40 %	1.79 %
Allowance for Loan and Lease Losses to Gross Loans and Leases at End of Period	1.58 %	2.28 %	2.63 %	2.68 %	1.60 %
Allowance for Loan Losses to Non-Performing Loans	26.13 %	30.80 %	46.00 %	50.49 %	50.67 %
Net Loan and Lease Charge-offs to Allowance for Loan Losses at End of Period	127.01 %	91.74 %	91.10 %	54.62 %	110.23 %
Net Loan Charge-offs to Provision for Loan and Lease Losses	124.00 %	132.13 %	115.45 %	60.04 %	85.52 %

As shown in the table immediately above, the Company's provision for loan and lease losses was increased by $2.210 million, or 18%, for 2012 relative to 2011. There was also an increase in net loans charged off in 2012, which were up by $1.765 million, or 11%, for the reasons noted above in the "Provision for Loan and Lease Losses" section. Gross real estate loan charge-offs totaled $11.108 million in 2012, reaching their highest level since the beginning of the recession and representing an increase of $512,000 over 2011, due in part to continued incremental write-downs on collateral-dependent loans. Gross charge-offs for commercial loans (including SBA-guaranteed loans) and consumer loans, at $4.270 million and $2.568 million, respectively, also remained at relatively high levels in 2012. Recoveries of loan principal that had previously been charged off, which were credited back to the allowance for loan and lease losses, totaled $1.158 million in 2012, approximately the same as in 2011. Since our allowance for loan and lease losses is maintained at a level to cover probable losses on specifically identified loans as well as probable incurred losses in the remaining loan portfolio, any shortfall in the allowance created by loan charge-offs is typically covered by month-end, and always by quarter-end. Additional details on our provision for loan and lease losses and its relationship to actual charge-offs is contained above in the "Provision for Loan and Lease Losses" section.

The Company's allowance for loan and lease losses at December 31, 2012 represents management's best estimate of probable losses in the loan portfolio as of that date. Fluctuations in credit quality, changes in economic conditions, or other factors could induce us to augment or reduce the allowance, however, and no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance.

Provided below is a summary of the allocation of the allowance for loan and lease losses for specific loan categories at the dates indicated. The allocation presented should not be viewed as an indication that charges to the allowance will be incurred in these amounts or proportions, or that the portion of the allowance allocated to a particular loan category represents the total amount available for charge-offs that may occur within that category.

Allocation of Allowance for Loan and Lease Losses

(dollars in thousands)

	As of December 31,														
	2012			2011			2010			2009			2008		
	Amount	%Total [(1)] Loans		Amount	%Total [(1)] Loans		Amount	%Total [(1)] Loans		Amount	%Total [(1)] Loans		Amount	%Total [(1)] Loans	
Agricultural	$258	2.56	%	$19	2.25	%	$62	1.67	%	$10	1.12	%	$17	1.43	%
Commercial and Industrial [(2)]	3,302	31.64	%	6,085	15.89	%	7,653	14.09	%	7,006	15.32	%	4,922	15.04	%
Real Estate	8,034	62.04	%	8,260	76.19	%	10,143	77.30	%	12,348	75.38	%	6,839	74.47	%
Consumer Loans	2,114	3.28	%	2,608	4.77	%	2,996	5.67	%	3,752	6.45	%	3,129	6.95	%
	165	0.48	%	311	0.90	%	284	1.27	%	599	1.73	%	187	2.11	%

Direct Financing Leases										
Total	$13,873	100.00%	$17,283	100.00%	$21,138	100.00%	$23,715	100.00%	$15,094	100.00%

(1) Represents percentage of loans in category to total loans

(2) Includes Small Business Administration loans

Investments

The Company's investments consist of debt and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank account, and overnight fed funds sold. Surplus Federal Reserve Bank balances and fed funds sold to correspondent banks represent the investment of temporary excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments were 28% of total assets at December 31, 2012, compared to 32% at December 31, 2011.

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We had no fed funds sold at December 31, 2012 or 2011. Interest-bearing balances held at other banks, consisting primarily of excess balance sheet liquidity placed in our Federal Reserve Bank account, totaled $20 million at both December 31, 2012 and December 31, 2011. The book balance of our investment portfolio was $380 million at December 31, 2012, relative to $406 million at the end of 2011. In the first quarter of 2012, surplus liquidity which was generated from growth in deposits and loan runoff was deployed into longer-term, agency-issued mortgage-backed securities and municipal bonds. However, we sold approximately $49 million in investment securities in the fourth quarter to help provide liquidity for loan growth, and our investment portfolio thus reflects a decline of $26 million, or 6%, for the year. Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management.

The following Investment Portfolio table reflects the amortized cost and fair market values for each primary category of investments for the past three years.

Investment Portfolio-Available for Sale

(dollars in thousands)

	As of December 31,					
	2012		2011		2010	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
US Government Agencies and Corporations	$2,988	$ 2,973	$2,008	$ 2,026	$4,954	$ 5,062
Mortgage-backed securities	298,806	301,389	328,751	331,758	252,320	255,143
State and political subdivisions	70,736	73,986	67,851	71,340	70,201	70,102
Equity securities	1,336	1,840	1,336	1,347	2,705	1,423
Total investment securities	$373,866	$ 380,188	$399,946	$ 406,471	$330,180	$ 331,730

U.S. Government agency securities increased by $1 million, or 47%, in 2012, since maturing balances were more than offset by purchases during the year. Mortgage-backed securities declined by $30 million, or 9%, during 2012, as purchases during the year were not of sufficient volume to make up for the aforementioned sale of bonds in the fourth quarter. The balance of municipal bonds increased by close to $3 million, or 4%, as the Company has taken advantage of relative value in that sector. All newly purchased municipal bonds have strong underlying ratings. No equity securities were bought or sold during 2012, although the market value of those securities increased by $493,000, or 37%. Investment securities pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled $179 million at December 31, 2012 and $208 million at December 31, 2011, leaving $200 million in unpledged debt securities at December 31, 2012 and $197 million at December 31, 2011. Securities pledged in excess of actual pledging needs, and thus available for liquidity purposes if necessary, totaled $79 million at December 31, 2012 and $112 million at December 31, 2011.

The investment maturities table below summarizes contractual maturities for the Company's investment securities and their weighted average yields at December 31, 2012. The actual timing of principal payments may differ from remaining contractual maturities, because obligors may have the right to prepay certain obligations.

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Maturity and Yield of Available for Sale Investment Portfolio

(dollars in thousands)

	December 31, 2012									
	Within One Year		After One But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
US Government agencies	$-	0.00 %	$978	1.12 %	$1,996	1.14 %	$-	0.00 %	$2,973	1.13 %
Mortgage-backed securities	11,372	-0.95 %	251,361	2.09 %	37,516	2.43 %	1,142	2.21 %	301,389	2.02 %
State and political subdivisions	2,133	5.33 %	10,026	5.83 %	33,069	5.82 %	28,757	4.27 %	73,986	5.20 %
Other equity securities	-	0.00 %	-	0.00 %	-	0.00 %	1,840	32.78 %	1,840	32.78 %
Total Investment Securities	$13,505		$262,364		$72,580		$31,739		$380,188	

Cash and Due from Banks

Cash on hand and non-interest bearing balances due from correspondent banks totaled $42 million at the end of 2012 and $43 million at the end of 2011, comprising 3% of total assets at December 31, 2012 and 2011. The actual balance of cash and due from banks at any given time depends on the timing of collection of outstanding cash items, among other things, and is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its short-term cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Reserve Bank and the Federal Home Loan Bank. Should a large “short” overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a “long” position is prevalent, the Company will let brokered deposits or other wholesale borrowings roll off as they mature, or might invest excess liquidity in higher-yielding, longer-term bonds.

Because of frequent balance fluctuations, a more accurate gauge of cash management efficiency is the average balance for the period. The $37 million average of non-earning cash and due from banks for 2012 was higher than the $35 million average for 2011, due in part to extra cash kept on hand to accommodate greater day-to-day fluctuations associated with a higher level of lending activity.

Premises and Equipment

Premises and equipment are stated on our books at cost, less accumulated depreciation and amortization. The cost of furniture and equipment is expensed as depreciation over the estimated useful life of the related assets, and leasehold improvements are amortized over the term of the related lease or the estimated useful life of the improvements, whichever is shorter. The following premises and equipment table reflects the original cost, accumulated depreciation and amortization, and net book value of fixed assets by major category, for the years noted:

Premises and Equipment

(dollars in thousands)

	As of December 31, 2012			2011			2010		
	Cost	Accumulated Depreciation and Ammortization	Net Book Value	Cost	Accumulated Depreciation and Ammortization	Net Book Value	Cost	Accumulated Depreciation and Ammortization	Net Book Value
Land	$2,607	$ -	$2,607	$2,607	$ -	$2,607	$2,549	$ -	$2,549
Buildings	15,720	7,259	8,461	16,662	6,843	9,819	12,322	5,548	6,774
Leasehold improvements	10,496	3,652	6,844	8,723	3,066	5,657	9,880	3,389	6,491
Construction in progress	4	-	4	12	-	12	1,033	-	1,033
Furniture and equipment	20,476	16,562	3,914	22,092	19,466	2,626	21,378	18,035	3,343
Total	$49,303	$ 27,473	$21,830	$50,096	$ 29,375	$20,721	$47,162	$ 26,972	$20,190

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Net premises and equipment increased by $1.1 million, or 5%, during 2012, due in large part to the purchase and installation of upgraded ATM's. The net book value of the Company's aggregate premises and equipment was 1.5% of total assets at December 31, 2012, and 1.6% at December 31, 2011. Depreciation and amortization included in occupancy and equipment expense was $2.3 million for the year ended December 31, 2012, as compared to $2.5 million in 2011. Depreciation on equipment leased to others is reflected in other operating costs.

Other Assets

The Company's goodwill, shown as a separate line item on the balance sheet, totaled $5.5 million at December 31, 2012 and 2011. It consists solely of goodwill that was generated in connection with our acquisition of Sierra National Bank in 2000. The Company's goodwill is evaluated annually for potential impairment, and because the estimated fair value of the Company exceeded its book value (including goodwill) as of the measurement date and no impairment was indicated, no further testing was deemed necessary and it was determined that no goodwill impairment existed.

The line item for "other assets" on the Company's balance sheet totaled $81.4 million at December 31, 2012, roughly the same as at December 31, 2011. At year-end 2012, other assets included as its largest components $38.0 million in bank-owned life insurance (see discussion of BOLI in "Non-Interest Revenue and Operating Expense" section above), an $8.7 million investment in low-income housing tax credit funds, a $6.4 million investment in restricted stock, a net deferred tax asset of $12.0 million, current prepaid income taxes totaling $3.8 million, and accrued interest receivable totaling $5.1 million. Restricted stock is comprised primarily of Federal Home Loan Bank of San Francisco ("FHLB") stock that typically experiences balance fluctuations in conjunction with our level of FHLB borrowings. This stock is not deemed to be marketable or liquid and is thus not grouped with the Company's investments described above. Management has evaluated all deferred tax assets as of every reporting date pursuant to FASB guidance, and concluded that neither the quality of the deferred tax assets nor the Company's future taxable income potential will preclude full realization of all amounts in future years.

Deposits

Another key balance sheet component impacting the Company's net interest margin is our deposits. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly non-maturity deposits, which include demand deposit accounts, NOW accounts, savings accounts, and money market demand accounts. Information concerning average balances and rates paid on deposits by deposit type for the past three fiscal years is contained in the Distribution, Rate, and Yield table located in the previous section under Results of Operations–Net Interest Income and Net Interest Margin. A distribution of the Company's deposits at December 31st for each year from 2008 through 2012, showing the balance and percentage of total deposits by type, is presented in the following table:

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Deposit Distribution

(dollars in thousands)

	Year Ended December 31,				
	2012	2011	2010	2009	2008
Interest Bearing Demand Deposits	$84,655	$68,777	$-	$-	$-
Non-interest Bearing Demand Deposits	352,597	300,045	251,908	233,204	232,168
NOW	196,771	187,155	184,360	151,821	100,949
Savings	118,547	91,376	74,682	62,279	55,373
Money Market	71,222	76,396	156,170	165,097	146,896
CDAR's < $100,000	791	943	1,614	12,937	49,296
CDAR's ≥ $100,000	14,274	17,119	31,652	129,194	63,364
Customer Time deposit < $100,000	101,893	106,610	164,223	147,390	115,303
Customer Time deposits ≥ $100,000	218,284	222,847	187,665	195,510	182,649
Brokered Deposits	15,000	15,000	-	28,000	115,500
Total Deposits	$1,174,034	$1,086,268	$1,052,274	$1,125,432	$1,061,498

Percentage of Total Deposits	2012		2011		2010		2009		2008	
Interest Bearing Demand Deposits	7.21	%	6.33	%	0.00	%	0.00	%	0.00	%
Non-interest Bearing Demand Deposits	30.03	%	27.62	%	23.94	%	20.72	%	21.87	%
NOW	16.76	%	17.23	%	17.52	%	13.49	%	9.51	%
Savings	10.10	%	8.41	%	7.10	%	5.53	%	5.22	%
Money Market	6.07	%	7.03	%	14.84	%	14.67	%	13.84	%
CDAR's < $100,000	0.07	%	0.09	%	0.15	%	1.15	%	4.64	%
CDAR's ≥ $100,000	1.22	%	1.58	%	3.01	%	11.48	%	5.97	%
Customer Time deposit < $100,000	8.68	%	9.81	%	15.61	%	13.10	%	10.86	%
Customer Time deposits ≥ $100,000	18.58	%	20.52	%	17.83	%	17.37	%	17.21	%
Brokered Deposits	1.28	%	1.38	%	0.00	%	2.49	%	10.88	%
Total	100.00	%	100.00	%	100.00	%	100.00	%	100.00	%

Furthermore, the scheduled maturity distribution of the Company’s time deposits at the end of 2012 was as follows:

Deposit Maturity Distribution

(dollars in thousands)	As of December 31, 2012					
	Three months or	Three to six months	Six to twelve months	One to three years	Over three years	Total
CDAR's	$12,756	$ 345	$ 1,964	$ -	$ -	$15,065
Time Certificates of Deposit < $100,000	66,063	21,801	14,785	13,493	751	116,893
Other Time Deposits ≥ $100,000	170,202	25,650	17,738	4,694	-	218,284
Total	$249,021	$ 47,796	$ 34,487	$ 18,187	$ 751	$350,242

Total deposit balances increased by $88 million, or 8%, during 2012. Our deposit mix improved during the year since the growth came in core non-maturity deposits, which were up $100 million, or 14%, and increased to 70% of total deposits at the end of 2012 from 67% at the end of 2011. Our customers appear to have a propensity to save due to lingering economic uncertainties, but the growth in non-maturity deposits is also due in part to an intensified focus on business relationships and ongoing deposit acquisition programs, including our highly successful direct mail initiatives. Those factors contributed to increases of $53 million, or 18%, in non-interest bearing demand deposits, $16 million, or 23%, in interest-bearing demand deposits, $10 million, or 5%, in NOW accounts, and $27 million, or 30%, in savings deposits. The only non-maturity deposit category to show a decline for the year is money market deposits, which were down $5 million, or 7%. Management is of the opinion that a relatively high level of core customer deposits is one of the Company’s key strengths, and we continue to focus energy toward deposit account retention and growth.

Customer time deposits under $100,000 declined by $5 million, or 4%, during 2012, due mainly to the non-renewal of time deposits under the management of our Treasury Department, and customer time deposits over $100,000 also declined by $5 million, or 2%. CDAR's deposits, which also represent time deposits that are primarily sourced from customers in our market areas, were down $3 million, or 17%, for the year, while the outstanding balance of wholesale-sourced brokered deposits remained at $15 million.

Other Borrowings

The Company's non-deposit borrowings include overnight borrowings from other banks ("fed funds purchased"), overnight and term advances from the Federal Home Loan Bank, securities sold under agreement to repurchase, and junior subordinated debentures that consist entirely of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities. In aggregate, we increased non-deposit borrowings by $8 million, or 12%, in 2012 to help fund loan growth.

Longer-term FHLB advances, having a remaining maturity of one year or more, totaled $5 million at December 31, 2012 and $15 million at December 31, 2011, reflecting a decline of $10 million. The Company also had $31 million in junior subordinated debentures at December 31, 2012 and December 31, 2011. The details of the Company's short-term borrowings for the years 2012, 2011, and 2010 are presented in the table below:

Short-term Borrowings (dollars in thousands)	Year Ended December 31,		
	2012	2011	2010
Repurchase Agreements			
Balance at December 31	$1,419	$3,037	$-
Average amount outstanding	3,441	2,371	-
Maximum amount outstanding at any month end	7,630	5,789	-
Average interest rate for the year	0.61 %	0.67 %	N/A
Fed funds purchased			
Balance at December 31	$-	$-	$-
Average amount outstanding	-	4	3
Maximum amount outstanding at any month end	-	35	-
Average interest rate for the year	N/A	0.19 %	0.32 %
FHLB advances			
Balance at December 31	$36,650	$17,120	$14,650
Average amount outstanding	15,234	5,637	16,044
Maximum amount outstanding at any month end	66,520	33,000	44,900
Average interest rate for the year	0.24 %	0.69 %	1.18 %

The Company uses overnight and short-term FHLB advances and fed funds purchased on uncommitted lines from correspondent banks to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit is dependent on the level of pledged collateral. We had no overnight fed funds purchased on our books at December 31, 2012 or December 31, 2011, however repurchase agreement balances totaled approximately $1 million at the end of 2012, down from $3 million at the end of 2011. Repurchase agreements represent customer sweep accounts, where deposit balances above a specified threshold are transferred at the close of every business day into non-deposit accounts secured by investment securities. Our short-term FHLB advances were comprised solely of overnight borrowings totaling $37 million at December 31, 2012, and $17 million at December 31, 2011.

Capital Resources

At December 31, 2012, the Company had total shareholders' equity of $173.9 million, comprised of common stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income. Total shareholders' equity at the end of 2011 was $168.6 million. The $5.3 million increase in shareholders' equity during 2012 was due in large part to net earnings of $8.2 million less $3.4 million in dividends paid. Total capital was also supplemented by increases related to the exercise of stock options and our accounting for unvested stock options, which added a combined total of $502,000 in 2012.

The Company uses a variety of measures to evaluate its capital adequacy, including risk-based capital and leverage ratios that are calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to help ensure that they meet or surpass established internal and external guidelines. The following table sets forth the Company's and the Bank's regulatory capital ratios as of the dates indicated.

	December 31, 2012		December 31, 2011	
Sierra Bancorp				
Total Capital to Total Risk-weighted Assets	19.36	%	21.72	%
Tier 1 Capital to Total Risk-weighted Assets	18.11	%	20.46	%
Tier 1 Leverage Ratio	13.34	%	14.11	%
Bank of the Sierra				
Total Capital to Total Risk-weighted Assets	19.14	%	20.89	%
Tier 1 Capital to Total Risk-weighted Assets	17.88	%	19.63	%
Tier 1 Leverage Ratio	13.17	%	13.53	%

As of the end of 2012, the Company and the Bank were both classified as "well capitalized," the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. We do not foresee any circumstances that would cause the Company or the Bank to be less than well capitalized, although no assurance can be given that this will not occur. For additional details on risk-based and leverage capital guidelines, requirements, and calculations, see "Item 1, Business – Supervision and Regulation – Capital Adequacy Requirements" and "Item 1, Business – Supervision and Regulation – Prompt Corrective Action Provisions" herein.

Liquidity and Market Risk Management

Liquidity

Liquidity refers to the Company's ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. Detailed cash flow projections are reviewed by management on a monthly basis, with various scenarios applied to simulate our ability to meet liquidity needs under adverse conditions. Liquidity ratios are also calculated and reviewed on a regular basis. While these ratios are merely indicators and are not measures of actual liquidity, they are monitored closely and we strive to maintain adequate liquidity resources to draw upon should unexpected liquidity needs arise.

The Company, on occasion, experiences cash needs as the result of loan growth, deposit outflows, asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, draw advances against FHLB lines of credit, or solicit brokered deposits if deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks, including the FHLB, totaled $179 million at December 31, 2012, which is net of any outstanding borrowings and/or FHLB letters of credit. An additional $197 million in credit is available from the Federal Home Loan Bank if the Company pledges sufficient additional collateral and maintains the required amount of FHLB stock. The Company is also eligible to borrow approximately $52 million at the Federal Reserve Discount Window, if necessary, based on pledged assets at December 31, 2012. Furthermore, funds can be obtained by drawing down the Company’s correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of December 31, 2012, unpledged debt securities, plus pledged securities in excess of current pledging requirements, comprised $279 million of the Company’s investment portfolio balances. Other forms of balance sheet liquidity include but are not necessarily limited to any outstanding fed funds sold and vault cash. The Company has a higher level of actual balance sheet liquidity than might otherwise be the case, since we utilize a letter of credit from the FHLB rather than investment securities for certain pledging requirements. The FHLB letter of credit totaled $64 million at December 31, 2012. Management is of the opinion that available investments and other potentially liquid assets, along with the standby funding sources it has arranged, are more than sufficient to meet the Company’s current and anticipated short-term liquidity needs.

The Company's net loans to assets and net non-core funding dependence ratios were 61% and 21%, respectively, at December 31, 2012, as compared to internal policy guidelines of "less than 78%" and "less than 50%." Other liquidity ratios reviewed by management and the Board include net loans to total deposits, wholesale funding to total assets (including ratios and sub-limits for the various components comprising wholesale funding), and available investments to assets, all of which were well within policy guidelines at December 31, 2012. Strong growth in core deposits and growth in investments have had a positive impact on our liquidity position in recent periods, although loan growth has absorbed much of the liquidity generated during 2012 and no assurance can be provided that our liquidity position will continue at current robust levels.

Interest Rate Risk Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital under a variety of interest rate scenarios. To identify areas of potential exposure to rate changes, the Company performs an earnings simulation analysis on a monthly basis and calculates the market value of portfolio equity under varying interest rate scenarios at least once every quarter.

The Company uses modeling software to simulate the effects of potential interest rate changes on projected net interest income and on the estimated fair values of the Company's financial instruments. The model imports balances, interest rates, maturity dates and re-pricing information for financial instruments on our balance sheet, and incorporates management's assumptions on the characteristics of embedded options along with pricing and duration for anticipated new volumes. Various rate scenarios, consisting of key rate and yield curve projections, are then applied in order to calculate the expected effect of a given interest rate change on the Company's projected interest income and interest expense. The rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

The Company uses eight standard interest rate scenarios in conducting its simulations: "stable," upward shocks of 100, 200, 300 and 400 basis points, and downward shocks of 100, 200, and 300 basis points. Pursuant to policy guidelines, we typically attempt to limit the projected 12-month decline in net interest income relative to the stable rate scenario to no more than 5% for a 100 basis point (b.p.) shock, 10% for a 200 b.p. shock, 15% for a 300 b.p. shock, and 20% for a 400 b.p. shock in interest rates. As of December 31, 2012 the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures or credit quality deterioration:

Immediate Change in Rate

	-300 b.p.	-200 b.p.	-100 b.p.	+100 b.p.	+200 b.p.	+300 b.p.	+400 b.p.
Change in Net Int. Inc. (in $000's)	$-10,650	$-7,336	$-3,716	$+1,815	$+3,643	$+5,669	$+7,566
% Change	-21.25%	-14.64%	-7.42%	+3.62%	+7.27%	+11.31%	+15.10%

Our current net interest income simulations indicate that the Company has an asset-sensitive profile, meaning that net interest income increases in rising interest rate scenarios but a drop in interest rates could have a negative impact. We have seen this profile steepen over the past couple of years, as we have benefited from an increasing proportion of lower-cost non-maturity deposits.

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If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be around $3.716 million lower than in a stable interest rate scenario, a drop of 7.42%. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates are already relatively low (on NOW accounts and savings accounts, for example), and will hit a natural floor of close to zero while variable-rate loan yields continue to drop. This effect is exacerbated by the fact that prepayments on fixed-rate loans and mortgage-backed securities tend to increase as rates decline, although rate floors on some of our variable-rate loans partially offset other negative pressures. While we view declining interest rates as highly unlikely, the potential percentage reduction in net interest income exceeds our internal policy guidelines in all three declining interest rate scenarios, and we will continue to monitor our interest rate risk profile and take corrective action as deemed appropriate.

Net interest income would likely improve by $1.815 million, or 3.62%, if interest rates were to increase by 100 basis points relative to a stable interest rate scenario, with the favorable variance expanding as interest rates rise higher. The initial increase in rising rate scenarios will likely be limited to some extent by the fact that many of our variable-rate loans are currently at rate floors, creating a re-pricing lag while variable rates are increasing to floored levels, but the Company still appears to be well-positioned to benefit from the eventuality of an upward shift in the yield curve.

The economic value (or “fair value”) of financial instruments on the Company’s balance sheet will also vary under the interest rate scenarios previously discussed. This variance is essentially a gauge of longer-term exposure to interest rate risk. It is measured by simulating changes in the Company’s economic value of equity (EVE), which is derived by subtracting the fair value of liabilities from the fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement interest rates for each account type, while the fair value of non-financial accounts is assumed to equal their book value for all rate scenarios. An economic value simulation is a static measure for balance sheet accounts at a given point in time, and the measurement can change substantially over time as the characteristics of the Company’s balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and management’s best estimates. We have found that model results are highly sensitive to changes in the assumed decay rate for non-maturity deposits, in particular. The table below shows estimated changes in the Company’s EVE as of December 31, 2012, under different interest rate scenarios relative to a base case of current interest rates:

Immediate Change in Rate

	-300 b.p.	-200 b.p.	-100 b.p.	+100 b.p.	+200 b.p.	+300 b.p.
Change in EVE (in $000's)	$-25,746	$-42,988	$-38,641	$+47,869	$+73,545	$+89,939
% Change	-8.50%	-14.19%	-12.75%	+15.80%	+24.27%	+29.68%

The table shows that our EVE will generally deteriorate in declining rate scenarios, but will benefit from rising rates. Our EVE profile has changed substantially in recent years, shifting from unfavorable exposure to a benefit in a rising interest rate environment, due in part to growth in non-maturity deposits and adjustments applied to deposit decay rates and loan prepayment rates in order to better reflect historical patterns. Effectively, lower deposit decay rates mean that we have a longer period to benefit from low-cost deposits, which are even more valuable when the cost of replacing them becomes greater as would be the case in a rising rate environment. However, the same changes that have improved our profile in rising rate scenarios have created greater exposure to declining rates. That negative impact is exacerbated by the acceleration of loan prepayment speeds in declining rate scenarios. While still negative relative to the base case, we see a decelerating decline in EVE as the drop in interest rates approaches 200 basis points and a favorable swing in EVE as interest rates drop from 200 basis points to 300 basis points. This is due to the longer duration of our fixed-rate assets relative to our fixed-rate liabilities, and the resulting impact of a significant rate decline on financial instrument fair values. As noted previously, however, management is of the opinion that the probability of a significant rate decline is low.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The information concerning quantitative and qualitative disclosures of market risk called for by Item 305 of Regulation S-K is included as part of Item 7 above. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Market Risk Management".

Item 8. Financial Statements and Supplementary Data

The following financial statements and independent auditors' reports listed below are included herein:

		Page
I.	Independent Auditor's Report from Vavrinek, Trine, Day & Co., LLP	60
II.	Consolidated Balance Sheets – December 31, 2012 and 2011	61
III.	Consolidated Statements of Income – Years Ended December 31, 2012, 2011, and 2010	62
IV.	Consolidated Statements of Comprehensive Income – Years Ended December 31, 2012, 2011, and 2010	63
V.	Consolidated Statements of Changes in Shareholders' Equity – Years Ended December 31, 2012, 2011, and 2010	64
VI.	Consolidated Statements of Cash Flows – Years Ended December 31, 2012, 2011, and 2010	65
VII.	Notes to Consolidated Financial Statements	67

Report of Independent Registered Public Accounting Firm

Board of Directors

Sierra Bancorp and Subsidiary

Porterville, California

We have audited the accompanying consolidated balance sheets of Sierra Bancorp and Subsidiary (the “Company”) as of December 31, 2012 and 2011, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sierra Bancorp and Subsidiary as of December 31, 2012 and 2011, and the results of its operations, changes in its shareholders' equity, and its cash flows for each of the years in the three year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2013 expressed an unqualified opinion thereon.

/s/ Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California

March 14, 2013

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SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

Years Ended December 31, 2012 and 2011

(dollars in thousands)

	2012	2011
ASSETS		
Cash and due from banks	$42,079	$42,805
Interest-bearing deposits in banks	19,739	20,231
Cash and cash equivalents	61,818	63,036
Investment securities available-for-sale	380,188	406,471
Loans held-for-sale	210	1,354
Loans and leases:		
Gross loans and leases	879,795	757,591
Allowance for loan and lease losses	(13,873)	(17,283)
Deferred loan and lease fees, net	1,156	621
Net Loans and Leases	867,078	740,929
Premises and equipment, net	21,830	20,721
Operating leases, net	12	384
Foreclosed assets	19,754	15,364
Goodwill	5,544	5,544
Other assets	81,469	81,602
Total Assets	$1,437,903	$1,335,405
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$352,597	$300,045
Interest bearing	821,437	786,223
Total Deposits	1,174,034	1,086,268
Federal funds purchased and repurchase agreements	1,419	3,037
Short-term borrowings	36,650	17,120
Long-term borrowings	5,000	15,000
Subordinated debentures	30,928	30,928
Other liabilities	15,980	14,488
Total liabilities	1,264,011	1,166,841

Commitments and contingencies (Note 11)		
Shareholders' equity		
Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued		
Common stock, no par value; 24,000,000 shares authorized; 14,106,959 and 14,101,609 shares issued and outstanding in 2012 and 2011 resectively	64,384	64,321
Additional paid in capital	2,660	2,221
Retained earnings	103,128	98,174
Accumulated other comprehensive income, net of taxes of $2,602 in 2012 and $2,676 in 2011	3,720	3,848
Total shareholders' equity	173,892	168,564
Total liabilities and shareholders' equity	$1,437,903	$1,335,405

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

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SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands, except per share data)

	2012	2011	2010
Interest income:			
Interest and fees on loans and leases	$45,765	$46,959	$53,057
Interest on investment securities:			
Taxable	6,364	8,753	8,025
Exempt from federal tax	2,703	2,834	2,709
Interest on Federal funds sold and interest-bearing deposits	70	68	40
Total interest income	54,902	58,614	63,831
Interest expense:			
Interest on deposits	3,208	4,305	6,121
Interest on short-term borrowings	58	55	190
Interest on long-term borrowings	281	569	604
Interest on subordinated debentures	774	728	734
Total interest expense	4,321	5,657	7,649
Net Interest Income	50,581	52,957	56,182
Provision for loan and lease losses	14,210	12,000	16,680
Net Interest Income after Provision for Loan and lease losses	36,371	40,957	39,502
Non-interest revenue:			
Service charges on deposit accounts	9,676	9,543	11,212
Gain on sale of loans	183	139	105
Credit card fees	390	411	391
Checkcard fees	2,787	2,519	2,261
Gains on sales and calls of investment securities available-for-sale	1,762	1,660	2,643
Other-than-temporary impairment losses on equity securities	-	(1,370)	-
Increase in cash surrender value of life insurance	1,420	934	1,382
Other income	1,908	1,156	1,271
Total non-interest revenue	18,126	14,992	19,265
Other operating expense:			

Salaries and employee benefits	20,734	20,669	20,869
Occupancy and equipment expense	6,381	6,758	7,040
Other	19,541	20,178	23,729
Total non-interest expense	46,656	47,605	51,638
Income before income taxes	7,841	8,344	7,129
Provision for income taxes	(344)	564	(234)
Net Income	$8,185	$7,780	$7,363
Earnings per share:			
Basic	$0.58	$0.55	$0.61
Diluted	$0.58	$0.55	$0.60

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands)

	2012	2011	2010
Net Income	$8,185	$7,780	$7,363
Other comprehensive income, before tax:			
Unrealized gains on securities:			
Unrealized holding gains (losses) arising during period	1,560	5,266	(501)
Less: reclassification adjustment for gains included in net income	(1,762)	(1,660)	(2,643)
Plus: reclassification adjustment or other-than- temporary impairment losses (non-credit portion)	-	1,370	-
Other comprehensive (expense) income, before tax	(202)	4,976	(3,144)
Income tax benefit (expense) related to items of other comprehensive income, net of tax	74	(2,026)	1,323
Other comprehensive (expense) income	(128)	2,950	(1,821)
Comprehensive income	$8,057	$10,730	$5,542

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Three Years Ended December 31, 2012

(dollars in thousands, except per share data)

	Common Stock		**Additional**		**Accumulated Other**	
	Shares	Amount	Paid In Capital	Retained Earnings	Comprehensive Income	Shareholders' Equity
Balance, January 1, 2010	11,620,491	$41,371	$ 1,248	$89,142	$ 2,719	$ 134,480
Net Income				7,363		7,363
Net change in unrealized gain on investment securities available-for-sale, net of tax					(1,821)	(1,821)
Issuance of Common stock	2,325,000	21,864				21,864
Exercise of stock options and related tax benefit	31,250	242	19			261
Stock compensation costs			385			385
Cash dividends - $.24 per share				(2,935)		(2,935)
Balance, December 31, 2010	13,976,741	63,477	1,652	93,570	898	159,597
Net Income				7,780		7,780
Net change in unrealized gain on investment securities available-for-sale, net of tax					2,950	2,950
Reversal of Cumulative effect of change in accounting principle (EITF 06-4)				191		191
Expense related to issuance of common stock		(23)				(23)
Exercise of stock options and related tax benefit	124,868	867	109			976
Stock compensation costs			460			460
Cash dividends - $.24 per share				(3,367)		(3,367)
Balance, December 31, 2011	14,101,609	64,321	2,221	98,174	3,848	168,564
Net Income				8,185		8,185

Net change in unrealized gain on investment securities available-for-sale, net of tax					(128)	(128)
Reversal of Cumulative effect of change in accounting principle (EITF 06-4)				154		154
Exercise of stock options and related tax benefit	5,350	63	(48)			15
Stock compensation costs			487			487
Cash dividends - $.24 per share				(3,385)		(3,385)
Balance, December 31, 2012	14,106,959	$64,384	$ 2,660	$103,128	$ 3,720	$ 173,892

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

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SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CASH FLOWS

Years Ended December 31, 2012, 2011, and 2010

(dollars in thousands)

	2012	2011	2010
Cash flows from operating activities:			
Net income	$8,185	$7,780	$7,363
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on investment of securities	(1,762)	$(1,660)	$(2,643)
Other-than-temporary impairment loss	-	1,370	-
Gain on sales of loans	(183)	(139)	(105)
Loss on disposal of fixed assets	30	25	243
Loss on sale of foreclosed assets	864	451	1,536
Writedown of foreclosed assets	3,173	4,184	5,045
Share-based compensation expense	487	460	385
Provision for loan losses	14,210	12,000	16,680
Depreciation and amortization	2,437	2,695	2,890
Net amortization on securities premiums and discounts	8,500	5,874	3,469
Increase in unearned net loan fees	(535)	(509)	(752)
Increase in cash surrender value of life insurance policies	(350)	(934)	(1,522)
Proceeds from sales of loans	8,191	7,210	2,705
Originations of Loans Held For Sale	(6,864)	(7,511)	(3,138)
Decrease in interest receivable and other assets	610	2,354	2,365
Increase (decrease) in other liabilities	1,646	666	(568)
Net decrease in FHLB stock, at cost	670	1,321	1,000
Deferred income tax benefit	(564)	(881)	(2,919)
Excess tax benefit from equity based compensation	(48)	(109)	(19)
Net cash provided by operating activities	38,697	34,647	32,015
Cash flows from investing activities:			
Maturities of securities available for sale	1,120	7,107	6,787
Proceeds from sales/calls of securities available for sale	63,776	46,872	75,319
Purchases of securities available for sale	(150,305)	(205,500)	(208,477)
Principal paydowns on securities available for sale	104,752	76,171	68,838
(Increase) decrease in loans receivable, net	(163,789)	24,661	48,930
Purchases of premises and equipment, net	(3,411)	(2,734)	(2,481)
Proceeds from sales of foreclosed assets	15,538	7,212	9,798

Purchase of bank owned life insurance	-	(5,132)	-
Net cash used in investing activities	(132,319)	(51,343)	(1,286)

(Continued)

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Continued)

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands)

	2012	2011	2010
Cash flows from financing activities:			
Increase (decrease) in deposits	87,766	33,994	(73,158)
Increase (decrease) in borrowed funds	9,530	2,470	(350)
(Decrease) increase in Repurchase Agreements	(1,618)	3,037	-
Cash dividends paid	(3,385)	(3,367)	(2,935)
(Expense) proceeds from issuance of Common Stock	-	(23)	21,864
Stock options exercised	63	867	242
Excess tax provision from equity based compensation	48	109	19
Net cash provided by financing activities	92,404	37,087	(54,318)
(Increase) Decrease in cash and due from banks	(1,218)	20,391	(23,589)
Cash and cash equivalents, beginning of year	63,036	42,645	66,234
Cash and cash equivalents, end of year	$61,818	$63,036	$42,645
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	$4,531	$5,492	$8,155
Income taxes	$-	$1,643	$5,360
Non-cash investing activities			
Real estate acquired through foreclosure	$23,965	$6,520	$15,993
Change in unrealized net (losses) gains on Investment securities available-for-sale	$(202)	$4,976	$(3,144)

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

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. THE BUSINESS OF SIERRA BANCORP

Sierra Bancorp (the "Company") is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended, and is headquartered in Porterville, California. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the "Bank") in August 2001. The Company's principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. The Company’s only other direct subsidiaries are Sierra Statutory Trust II, which was formed in March 2004 solely to facilitate the issuance of capital trust pass-through securities, and Sierra Capital Trust III, which was formed in June 2006 also for the purpose of issuing capital trust pass-through securities.

The Bank operates twenty-five full service branch offices, one online “virtual” branch and two credit centers. The Bank's deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable legal limits. The Bank maintains a diversified loan portfolio comprised of agricultural, commercial, consumer, real estate construction and mortgage loans. Loans are made primarily within the market area of the South Central San Joaquin Valley of California, specifically, Tulare, Fresno, Kern, Kings, and Madera counties. These areas have diverse economies with principal industries being agriculture, real estate and light manufacturing.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of the Company and the consolidated accounts of its wholly-owned subsidiary, Bank of the Sierra. All significant intercompany balances and transactions have been eliminated. Certain reclassifications have been made to prior years' balances to conform to classifications used in 2012. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and prevailing practices within the banking industry.

In accordance with U.S. GAAP, the Company's investments in Sierra Statutory Trust II and Sierra Capital Trust III are not consolidated and are accounted for under the equity method and included in other assets on the consolidated

balance sheet. The subordinated debentures issued and guaranteed by the Company and held by the trusts are reflected on the Company's consolidated balance sheet.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these 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 and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for loan and lease losses and other real estate, management obtains independent appraisals for significant properties, evaluates the overall loan portfolio characteristics and delinquencies and monitors economic conditions.

Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and interest bearing deposits in banks.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Investment Securities

Investments are classified into the following categories:

- Securities available-for-sale, reported at fair value, with unrealized gains and losses excluded from earnings and reflected, net of tax, as a separate component of shareholders' equity in accumulated other comprehensive income.

- Securities held-to-maturity, which the Company has the intent and has the ability to hold to maturity, are carried at cost, adjusted for amortization of premiums and the accretion of discounts.

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Loans and Leases (Financing Receivables)

Our credit quality classifications of Loans and Leases include Pass, Special Mention, Substandard and Impaired. These classifications are defined in Note 4 (Loans and Leases) to our consolidated financial statements.

Loans and leases are reported at the principal amounts outstanding, adjusted for unearned income, deferred loan origination fees and costs, purchase premiums and discounts, write-downs, and the allowance for loan and lease losses. Loan and lease origination fees, net of certain deferred origination costs, and purchase premiums and discounts are recognized as an adjustment to yield of the related loans and leases over the contractual life of the loan using both the effective interest and straight line methods.

Interest income for all performing loans, regardless of classification (Pass, Special Mention, Substandard and Impaired), is recognized on an accrual basis, with interest accrued daily. Costs associated with successful loan originations are netted from loan origination fees, with the net amount (net deferred loan fees) amortized over the contractual life of the loan in interest income. If a loan has scheduled periodic payments, the amortization of the net deferred loan fee is calculated using the effective interest method over the contractual life of the loan. If the loan does not have scheduled payments, such as a line of credit, the net deferred loan fee is recognized as interest income on a straight line basis over the contractual life of the loan. Fees received for loan commitments are recognized as interest income over the term of the commitment. When loans are repaid, any remaining unamortized balances of deferred fees and costs are accounted for through interest income.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Generally, the Company places loans and leases, regardless of class on nonaccrual status and ceases recognizing interest income when the loan has become delinquent more than 90 days and/or when Management determines that the repayment of principal and collection of interest is unlikely. The Company may decide that it is appropriate to continue to accrue interest on certain loans more than 90 days delinquent if they are well-secured by collateral and collection is in process. When a loan is placed on nonaccrual status, any accrued but uncollected interest for the loan is reversed out of interest income in the period in which the loan's status changed. Subsequent payments received from the customer are applied to principal, and no further interest income is recognized until the principal has been paid in full or until circumstances have changed such that payments are again consistently received as contractually required.

Impaired loans are classified as either nonaccrual or accrual, depending on individual circumstances regarding the collectability of interest and principal according to the contractual terms. For performing impaired loans and leases, interest income is accrued and recognized on a daily basis and applied to current income. For nonaccrual impaired loans and leases, all unpaid accrued interest is reversed against current income, unless the loan or lease is well secured and in the process of collection. Interest received on nonaccrual impaired loans and leases is generally applied to principal or reported as interest income, according to management's judgment as to the collectability of principal. The accrual of interest on loans and leases is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due.

For loans with an interest reserve, i.e., where loan proceeds are advanced to the borrower to make interest payments, all interest recognized from the inception of the loan is reversed when the loan is placed on non-accrual.

Generally, loans and leases are restored to accrual status when the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt. Direct financing leases are carried net of unearned income. Income from leases is recognized by a method that approximates a level yield on the outstanding net investment in the lease.

Loans Modified in a Troubled Debt Restructuring

Loans are considered to have been modified in a troubled debt restructuring ("TDR") when due to a borrower's financial difficulties the Company makes certain concessions to the borrower that it would not otherwise consider. Modifications may include interest rate reductions, principal or interest forgiveness, forbearance, and other actions intended to minimize economic loss and to avoid foreclosure or repossession of collateral. Generally, a non-accrual loan that has been modified in a TDR remains on non-accrual status for a period of six months to demonstrate that the borrower is able to meet the terms of the modified loan. However, performance prior to the modification, or significant events that coincide with the modification, are included in assessing whether the borrower can meet the new terms and may result in the loan being returned to accrual status at the time of loan modification or after a shorter performance period. If the borrower's ability to meet the revised payment schedule is uncertain, the loan remains on non-accrual status. TDRs may be removed from TDR designation in the calendar year following the restructuring, if the loan is in compliance with all modified terms and is yielding a market rate of interest.

A TDR is generally considered to be in default when it appears likely that the customer will not be able to repay all principal and interest pursuant to the terms of the restructured agreement.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses

The allowance for loan and lease losses is maintained at a level which, in management's judgment, is adequate to absorb loan and lease losses inherent in the loan and lease portfolio. The allowance for loan and lease losses is increased by a provision for loan and lease losses, which is charged to expense, and reduced by charge-offs, net of recoveries. The amount of the allowance is based on management's evaluation of the collectability of the loan and lease portfolio, changes in its risk profile, credit concentrations, historical trends, and economic conditions. This evaluation also considers the balance of impaired loans and leases. A loan or lease is impaired when it is probable that the Bank will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan or lease agreement. Losses on individually identified loans or leases are measured based on the present value of expected future cash flows discounted at the original effective interest rate of the loan or lease, with any changes over time recognized as bad debt expense in our provision for loan losses. As a practical expedient, impairment may be measured based on the loan's or lease's observable market price or the fair value of the collateral if the loan or lease is collateral dependent. The amount of impairment, if any, is recorded through the provision for loan and lease losses and is added to the allowance for loan and lease losses. One-to-four family residential mortgages and consumer installment loans are subjected to a collective evaluation for impairment, considering delinquency and repossession statistics, historical loss experience, and other factors.

General reserves cover non-impaired loans and are based on historical migration net loss rates for each portfolio segment by call report code, adjusted for the effects of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio segment’s historical loss experience. Qualitative factors include consideration of the following: changes in lending policies and procedures; changes in international, national, regional, and local economic and business conditions and developments; changes in nature and volume of the portfolio; changes in the experience, ability and depth of lending management and other relevant staff; changes in the volume and severity of past due, nonaccrual and other adversely graded loans; changes in quality of the loan review system; changes in the value of the underlying collateral for collateral-dependent loans; concentrations of credit; and the effect of the other external factors such as competition and legal and regulatory requirements.

Most of the Company's business activity is with customers located within the Central Valley of California; primarily Fresno, Kings, Tulare and Kern Counties. Therefore, the Company's exposure to credit risk is significantly affected by changes in the economy in these counties. The Company considers this concentration of credit risk when assessing and assigning qualitative factors in the allowance for loan losses. Portfolio segments identified by the Company include Direct Financing leases, Agricultural, Commercial and Industrial, Real Estate, Small Business Administration, and Consumer loans. Relevant risk characteristics for these portfolio segments generally include debt service coverage, loan-to-value ratios and financial performance on non-consumer related loans; and credit scores, debt-to-income ratios, collateral type and loan-to-value ratios for consumer related loans.

Though management believes the allowance for loan and lease losses to be adequate, ultimate losses may vary from their estimates. However, estimates are reviewed periodically, and as adjustments become necessary, they are reported in earnings during periods they become known. In addition, the FDIC and the California Department of Financial Institutions, as an integral part of their examination processes, review the allowance for loan and lease losses. These agencies may require additions to the allowance for loan and lease losses based on their judgment about information available at the time of their examinations.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Reserve for Off-Balance Sheet Commitments

In addition to the exposure to credit loss from outstanding loans, the Company is also exposed to credit loss from certain off-balance sheet commitments such as unused commitments from revolving lines of credit, mortgage warehouse lines of credit, unused commitments on construction loans and commercial and standby letters of credit. Because the available funds have not yet been disbursed on these commitments the estimated losses are not included in the calculation of ALLL. The reserve for off-balance sheet commitments is an estimated loss contingency which is included in other liabilities on the Consolidated Balance Sheets. The adjustments to the reserve for off-balance sheet commitments are reported as a noninterest expense. This reserve is for estimated losses that could occur when the Company is contractually obligated to make a payment under these instruments and must seek repayment from a party that may not be as financially sound in the current period as it was when the commitment was originally made.

Sale and Servicing of Loans

The Company periodically originates loans intended to be sold on the secondary market. These loans are recorded as held for sale and reported at the lower of cost or fair value in the Consolidated Balance Sheets. The loan’s cost basis includes unearned deferred fees and costs, and premiums and discounts. These loans are generally held between 30 to 90 days from their origination date. Loans held for sale by the Company currently consist entirely of residential real estate loans. Loans classified as held for sale are disclosed in Note 4, “Loans” of these Consolidated Financial Statements.

Gains and losses on sales of loans are recognized at the time of sale and are calculated based on the difference between the selling price and the allocated book value of loans sold. Book value allocations are determined in accordance with U.S. GAAP. Any inherent risk of loss on loans sold is transferred to the buyer at the date of sale.

The Company has issued various representations and warranties associated with the sale of loans. These representations and warranties may require the Company to repurchase loans with underwriting deficiencies as defined per the applicable sales agreements and certain past due loans within 90 days of the sale. The Company did not experience losses during the years ended December 31, 2012, 2011 or 2010 regarding these representations and warranties.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The useful lives of premises are estimated to be thirty years. The useful lives of furniture, fixtures and equipment are estimated to be three to twenty years. Leasehold improvements are amortized over the life of the asset or the term of the related lease, whichever is shorter. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred.

Impairment of long-lived assets is evaluated by management based upon an event or changes in circumstances surrounding the underlying assets which indicate long-lived assets may be impaired.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Foreclosed Assets

Foreclosed assets include real estate, and other property acquired in full or partial settlement of loan obligations. When property is acquired, any excess of the recorded investment in the loan balance and accrued interest income over the appraised fair market value of the property, net of estimated selling costs, is charged against the allowance for loan and lease losses. A valuation allowance for losses on foreclosed assets is maintained to provide for temporary declines in value. The allowance is established through a provision for losses on foreclosed assets which is included in other non-interest expense. Subsequent gains or losses on sales or write-downs resulting from permanent impairments are recorded in other non-interest income or expense as incurred.

Goodwill

The Company acquired Sierra National Bank in 2000, and the acquisition was accounted for using the purchase method of accounting. The goodwill resulting from this transaction represents the amount by which the purchase price exceeded the fair value of the net assets. In accordance with U.S. GAAP the Company evaluates goodwill periodically for impairment. There was no impairment recognized for the years ended December 31, 2012, 2011, and 2010.

Income Taxes

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

Income taxes are accounted for using the asset and liability method. Under the asset and liability method, deferred taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred taxes of a change in tax rates would be recognized in income in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

The Company adopted guidance issued by the FASB *accounting for income taxes,* effective January 1, 2007, which clarifies the accounting and disclosure for uncertainty in tax positions as defined. This guidance seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely to be realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. We have determined that as of December 31, 2012 all tax positions taken to date are highly certain and, accordingly, no accounting adjustment has been made to the financial statements.

The Company recognizes interest and penalties related to uncertain tax positions as part of income tax expense.

Salary Continuation Agreements and Directors' Retirement Plan

The Company has entered into agreements to provide members of the Board of Directors and certain key executives, or their designated beneficiaries, with annual benefits for up to fifteen years after retirement or death. The Company accrues for these future benefits from the effective date of the plan until the director's or executive's expected retirement date in a systematic and rational manner. At the consolidated balance sheet date, the amount of accrued benefits equals the then present value of the benefits expected to be provided to the director or employee, any beneficiaries, and covered dependents in exchange for the director's or employee's services to that date.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Comprehensive Income

Comprehensive income consists of net income and the net change in unrealized gains on securities available-for-sale, net of an adjustment for the effects of realized gains and losses and any applicable tax. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income that historically has not been recognized in the calculation of net income. Unrealized gains and losses on the Company's available-for-sale investment securities are included in other comprehensive income after the adjustment for the effects of realized gains and losses. Total comprehensive income and the components of accumulated other comprehensive income (loss) are presented in the consolidated statements of comprehensive income.

Stock-Based Compensation

At December 31, 2012, the Company had one stock-based compensation plan, the Sierra Bancorp 2007 Stock Incentive Plan (the “2007 Plan”), which was adopted by the Company’s Board of Directors on March 15, 2007 and approved by the Company’s shareholders on May 23, 2007. The 2007 Plan is for 1,500,000 shares of the Company’s authorized but unissued common stock, subject to adjustment for stock splits and dividends, and provides for the issuance of both “incentive” and “nonqualified” stock options to salaried officers and employees, and of “nonqualified” stock options to non-employee directors. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants. We have not issued, nor do we currently have plans to issue, restricted stock awards. The 2007 plan supersedes the Company’s 1998 Stock Option plan (“1998 Plan”) which was terminated. The outstanding options issued under the 1998 Plan were not affected by this termination.

The Company is using the Black-Scholes model to value stock options. The “multiple option” approach is used to allocate the resulting valuation to actual expense for current period. Expected volatility is based on historical volatility of the Company’s common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable.

The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. The fair value of each option is estimated on the date of grant using the following assumptions:

	Years Ended December 31,					
	2012		2011		2010	
Dividend yield	2.35	%	2.27	%	2.24	%
Expected Volatility	56.71	%	52.92	%	54.22	%
Risk-free interest rate	0.43	%	1.06	%	1.18	%
Expected option life	5.5 years		6.8 years		5.8 years	

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2011-08, Intangibles—Goodwill and Other (Topic 350) - Testing Goodwill for Impairment. The objective of ASU 2011-08 is to simplify how entities test goodwill for impairment. Topic 350 requires an entity to test goodwill for impairment on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Pursuant to ASU 2011-08, an entity will not be required to calculate the fair value of a reporting unit and perform step one unless, after assessing qualitative factors, the entity determines that it is more likely than not that its fair value is less than its carrying amount. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of ASU 2011-08 did not have an impact on the Company's financial statements, as the Company has not been required to perform the second step of the goodwill impairment test since the first step has, to date, determined that the fair value of the reporting unit, Bank of the Sierra, is greater than its carrying amount.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income. Current U.S. generally accepted accounting principles allow reporting entities several alternatives for displaying other comprehensive income and its components in financial statements, and ASU 2011-05 is intended to improve the consistency of this reporting issue. The amendments in this ASU require all non-owner changes in stockholders' equity to be presented either in a single continuous statement of comprehensive income, or in two separate but consecutive statements. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in the statement of net income. The statement of other comprehensive income should immediately follow the statement of net income and include the components of other comprehensive income and a total for other comprehensive income, along with a total for comprehensive income. Furthermore, the entity is required to present, on the face of the financial statements, adjustments for items that are reclassified from other comprehensive income to net income in the statements, where the components of net income and the components of other comprehensive income are presented. The amendments in the ASU do not change the following: 1) items that must be reported in other comprehensive income; 2) when an item

of other comprehensive income must be reclassified to net income; 3) the option to present components of other comprehensive income either net of related tax effects or before related tax effects; or, 4) how earnings per share is calculated or presented. The amendments in ASU 2011-05 should be applied retrospectively. For public entities, such as the Company, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company's adoption of this ASU impacted our presentation of comprehensive income, but not the calculation of such.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs, to substantially converge the fair value measurement and disclosure guidance in U.S. GAAP with International Financial Reporting Standards (“IFRS”). The amended guidance changes several aspects of current fair value measurement guidance, including the following provisions: 1) the application of the concepts of “highest and best use” and “valuation premise”; 2) the introduction of an option to measure groups of offsetting assets and liabilities on a net basis; 3) the incorporation of certain premiums and discounts in fair value measurements; and, 4) the measurement of the fair value of certain instruments classified in shareholders’ equity. In addition, the amended guidance includes several new fair value disclosure requirements, including, among other things, information about valuation techniques and unobservable inputs used in Level 3 fair value measurements and a narrative description of Level 3 measurements’ sensitivity to changes in unobservable inputs. For public entities such as the Company, the provisions of ASU 2011-04 are effective for interim and annual periods beginning after December 15, 2011, and are to be applied prospectively. The implementation of ASU 2011-04 enhanced our footnote disclosures, but did not change fair value measurements for any of the Company’s assets or liabilities carried at fair value and thus did not impact the Company’s statements of income and condition.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE

The amortized cost and estimated fair value of investment securities available-for-sale are as follows (dollars in thousands):

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	$2,987	$ 3	$ (17)	$ 2,973
Obligations of state and political subdivisions	70,736	3,430	(180)	73,986
U.S. Government agencies collateralized by mortgage obligations	298,806	3,547	(964)	301,389
Equity Securities	1,336	508	(4)	1,840
	$373,865	$ 7,488	$ (1,165)	$ 380,188

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	$2,008	$ 18	$ -	$ 2,026
Obligations of state and political subdivisions	67,851	3,634	(145)	71,340
U.S. Government agencies collateralized by mortgage obligations	328,751	4,467	(1,460)	331,758
Equity Securities	1,336	11	-	1,347
	$399,946	$ 8,130	$ (1,605)	$ 406,471

For the years ended December 31, 2012, 2011, and 2010, proceeds from sales of securities available-for-sale were $56.4 million, $45.7 and $69.0 respectively. Gains and losses on the sale of investment securities are recorded on the trade date and are determined using the specific identification method.

Gross gains and losses from the sales and calls of investment securities for the years ended were as follows (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Gross Gains on Sales and Calls of Investment Securities	$ 2,059	$ 1,666	$ 2,643
Gross Losses on Sales and Calls of Investment Securities	(297)	(6)	-
Net Gains on Sales and Calls of Investment Securities	$ 1,762	$ 1,660	$ 2,643

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE (Continued)

At December 31, 2012 and 2011, the Company had 89 and 80 securities with unrealized gross losses, respectively. Information pertaining to these securities aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows (dollars in thousands):

	December 31, 2012			
	Less Than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Government agencies	$(17)	$1,996	$ -	$ -
Obligations of state and political subdivisions	(180)	9,324	-	-
U.S. Government agencies collateralized by mortgage obligations	(903)	106,799	(61)	6,965
Other Securities	(4)	242	-	-
Total	$(1,104)	$118,361	$ (61)	$ 6,965

	December 31, 2011			
	Less Than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Government agencies	$-	$-	$ -	$ -
Obligations of state and political subdivisions	(26)	1,735	(119)	1,978
U.S. Government agencies collateralized by mortgage obligations	(1,433)	144,953	(28)	949
Other Securities	-	-	-	-
Total	$(1,459)	$146,688	$ (147)	$ 2,927

The Company has reviewed all sectors and securities in the investment portfolio for impairment. During the year ended December 31, 2012, the Company realized losses through earnings from the sale of 22 debt securities for $297,000. The securities were sold with 129 other debt securities for which $2,052,000 in gains were realized, as a part of a liquidity strategy to fund new loan growth. During the year ended December 31, 2011 the Company realized a loss through earnings on five equity securities for $1,370,000. The referenced securities were previously carried on the Company's books at their fair market values with mark to market adjustments applied directly to equity. Since the securities were in a continuous loss position since mid-2008 and the near-term prospect of price recovery was increasingly uncertain, the Company recognized the loss through earnings.

The Company has concluded as of December 31, 2012 that all remaining securities, currently in an unrealized loss position, are not other-than-temporarily-impaired. This assessment was based on the following factors: 1) the Company has the ability to hold the security, 2) the Company does not intend to sell the security, 3) the Company does not anticipate it will be required to sell the security before recovery, 4) and the Company expects to eventually recover the entire amortized cost basis of the security.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE (Continued)

The amortized cost and estimated fair value of investment securities available-for-sale at December 31, 2012 by contractual maturity are shown below. 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 penalties.

	Amortized Cost	Fair Value
	(dollars in thousands)	
Maturing within one year	$2,110	$2,134
Maturing after one year through five years	203,744	206,701
Maturing after five years through ten years	70,475	72,579
Maturing after ten years	29,215	29,899
Investment securities not due at a single maturity date:		
U.S Government agencies collateralized by mortgage obligations	66,986	67,035
Other securities	1,336	1,840
	$373,866	$380,188

Investment securities available-for-sale with amortized costs totaling $174,930,000 and estimated fair values totaling $178,550,000 were pledged to secure public deposits, other contractual obligations and short-term borrowing arrangements at December 31, 2012. (see Note 8)

Investment securities available-for-sale with amortized costs totaling $203,494,000 and estimated fair values totaling $207,940,000 were pledged to secure other contractual obligations and short-term borrowing arrangements at December 31, 2011. (see Note 8)

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES

The composition of the loan and lease portfolio is as follows (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Real estate:		
Secured by residential, commercial and professional office properties, including construction and development	$303,424	$328,973
Secured by residential properties	170,514	188,117
Secured by farm land	71,851	60,142
Total Real Estate Loans	545,789	577,232
Agricultural	22,482	17,078
Commercial and industrial	257,896	99,408
Small Business Administration loans	20,523	21,006
Direct Financing leases	4,233	6,743
Consumer	28,872	36,124
Total Loans	879,795	757,591
Deferred loan and lease origination cost, net	1,156	621
Allowance for loan and lease losses	(13,873)	(17,283)
Loans, net	$867,078	$740,929

The Company monitors the credit quality of loans on a continuous basis using the regulatory and accounting classifications of pass, special mention, substandard and impaired to characterize and qualify the associated credit risk. Loans classified as “loss” are immediately charged-off. The Company uses the following definitions of risk classifications:

Pass – Loans listed as pass include larger non-homogeneous loans not meeting the risk rating definitions below and smaller, homogeneous loans not assessed on an individual basis.

Special Mention – Loans classified as special mention have the potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position and some future date.

Substandard – Loans classified as substandard are those loans with clear and at well-defined weaknesses such as a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or poor financial condition, which may jeopardize ultimate recoverability of the debt.

Impaired – 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 according to the contractual terms of the loan agreement. Additionally, all loans classified as troubled debt restructurings are considered impaired.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Credit quality classifications as of December 31, 2012 were as follows (dollars in thousands):

	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$1,599	$1,333	$ 89	$153	$3,174
Other Construction/Land	13,270	952	1,132	12,648	28,002
1-4 family - closed-end	73,002	2,484	1,208	23,222	99,916
Equity Lines	58,161	96	1,949	1,258	61,464
Multi-family residential	5,351	609	-	-	5,960
Commercial real estate owner occupied	144,207	22,895	6,562	8,950	182,614
Commercial real estate Non-owner occupied	67,407	6,864	568	17,969	92,808
Farmland	64,176	2,216	3,526	1,933	71,851
Total Real Estate	427,173	37,449	15,034	66,133	545,789
Agricultural	21,333	462	24	663	22,482
Commercial and Industrial	247,375	5,020	1,845	3,656	257,896
Small Business Administration loans	15,002	1,551	743	3,227	20,523
Direct finance leases	4,076	22	-	135	4,233
Consumer loans	23,881	445	198	4,348	28,872
Total Gross Loans and Leases	$738,840	$44,949	$ 17,844	$78,162	$879,795

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Credit quality classifications as of December 31, 2011 were as follows (dollars in thousands):

	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$4,240	$2,004	$ -	$2,244	$8,488
Other Construction/Land	18,185	8,873	1,015	11,987	40,060
1-4 family - closed-end	75,765	7,574	1,354	20,260	104,953
Equity Lines	62,867	456	1,795	1,379	66,497
Multi-family residential	4,620	618	-	2,941	8,179
Commercial real estate owner occupied	141,245	23,289	8,878	9,658	183,070
Commercial real estate Non-owner occupied	64,746	7,463	4,514	29,120	105,843
Farmland	47,719	1,878	3,626	6,919	60,142
Total Real Estate	419,387	52,155	21,182	84,508	577,232
Agricultural	15,477	1,574	27	-	17,078
Commercial and Industrial	83,780	7,529	3,078	5,021	99,408
Small Business Administration loans	16,251	-	852	3,903	21,006
Direct finance leases	6,089	63	-	591	6,743
Consumer loans	30,004	1,006	808	4,306	36,124
Total Gross Loans and Leases	$570,988	$62,327	$ 25,947	$98,329	$757,591

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

A summary of the transactions in the allowance for loan and lease losses follows (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Balance, beginning of year	$17,283	$21,138	$23,715
Provision for loan and lease losses	14,210	12,000	16,680
Losses charged to allowance	(18,778)	(16,987)	(20,337)
Recoveries	1,158	1,132	1,080
Balance, end of year	$13,873	$17,283	$21,138

Loans may or may not be collateralized, and collection efforts are continuously pursued. Loans or leases may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Loans and leases are charged off when they are deemed to be uncollectible, while recoveries are generally recorded only when cash payments are received subsequent to the charge-off.

The following table presents the activity in the allowance for loan losses for the year 2012 and the recorded investment in loans and impairment method as of December 31, 2012 by portfolio segment (dollars in thousands):

	Real Estate	Agricultural Products	Commercial and Industrial	Small Business Administration	Direct Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning of year	$ 8,260	$ 19	$ 4,638	$ 1,447	$ 311	$ 2,608	$ 17,283
Charge-offs	(11,108)	(634)	(3,517)	(753)	(198)	(2,568)	(18,778)

Recoveries	302	-	483	95	-	278	1,158
Provision	10,580	873	452	457	52	1,796	14,210
End of year	$ 8,034	$ 258	$ 2,056	$ 1,246	$ 165	$ 2,114	$ 13,873
Reserves:							
Specific	$ 4,180	$ 28	$ 934	$ 1,038	$ 67	$ 878	$ 7,125
General	3,854	230	1,122	208	98	1,236	6,748
	$ 8,034	$ 258	$ 2,056	$ 1,246	$ 165	$ 2,114	$ 13,873
Loans evaluated for impairment:							
Individually	$ 66,133	$ 663	$ 3,656	$ 3,227	$ 135	$ 4,348	$ 78,162
Collectively	479,656	21,819	254,240	17,296	4,098	24,524	801,633
	$ 545,789	$ 22,482	$ 257,896	$ 20,523	$ 4,233	$ 28,872	$ 879,795

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

The following table presents the activity in the allowance for loan losses for the year 2011 and the recorded investment in loans and impairment method as of December 31, 2011 by portfolio segment (dollars in thousands):

	Real Estate	Agricultural Products	Commercial and Industrial	Small Business Administration	Direct Finance Leases	Consumer	Total
Allowance for credit losses:							
Beginning of year	$ 10,143	$ 62	$ 6,379	$ 1,274	$ 284	$ 2,996	$ 21,138
Charge-offs	(10,596)	-	(3,407)	(148)	(82)	(2,754)	(16,987)
Recoveries	418	-	323	71	57	263	1,132
Provision	8,295	(43)	1,343	250	52	2,103	12,000
End of year	$ 8,260	$ 19	$ 4,638	$ 1,447	$ 311	$ 2,608	$ 17,283
Reserves:							
Specific	$ 5,229	$ -	$ 1,481	$ 1,212	$ 291	$ 541	$ 8,754
General	3,031	19	3,157	235	20	2,067	8,529
	$ 8,260	$ 19	$ 4,638	$ 1,447	$ 311	$ 2,608	$ 17,283
Loans evaluated for impairment:							
Individually	$ 84,508	$ -	$ 5,021	$ 3,903	$ 591	$ 4,306	$ 98,329
Collectively	492,724	17,078	94,387	17,103	6,152	31,818	659,262
	$ 577,232	$ 17,078	$ 99,408	$ 21,006	$ 6,743	$ 36,124	$ 757,591

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Past due and nonaccrual loans as of December 31, 2012 were as follows (dollars in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[2]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[1]
Real Estate:							
1-4 family residential construction	$ -	$ -	$ 153	$ 153	$ 3,021	$ 3,174	$ 153
Other Construction/Land	374	211	-	585	27,417	28,002	11,163
1-4 family - closed-end	1,335	88	376	1,799	98,117	99,916	15,381
Equity Lines	473	40	66	579	60,885	61,464	1,026
Multi-family residential	177	-	-	177	5,783	5,960	-
Commercial real estateowner occupied	1,372	813	1,289	3,474	179,140	182,614	5,314
Commercial real estate Non-owner occupied	7,831	-	1,499	9,330	83,478	92,808	11,642
Farmland	231	-	1,679	1,910	69,941	71,851	1,933
Total Real Estate Loans	11,793	1,152	5,062	18,007	527,782	545,789	46,612
Agricultural	24	157	506	687	21,795	22,482	664
Commercial and Industrial	1,419	518	7	1,944	255,952	257,896	2,386
Small Business Administration Loans	905	-	1,574	2,479	18,044	20,523	2,159
Direct finance leases	-	34	123	157	4,076	4,233	135
Consumer loans	238	189	87	514	28,358	28,872	1,138
Total Gross Loans and Leases	$ 14,379	$ 2,050	$ 7,359	$ 23,788	$ 856,007	$ 879,795	$ 53,094

[1] Included in Total Financing Receivables

[2] As of December 31, 2012 there were no loans over 90 days past due and still accruing.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Past due and nonaccrual loans as of December 31, 2011 were as follows (dollars in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[2]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[1]
Real Estate:							
1-4 family residential construction	$ -	$ -	$ -	$ -	$ 8,488	$ 8,488	$ 2,244
Other Construction/Land	1,354	-	1,417	2,771	37,289	40,060	4,083
1-4 family - closed-end	1,777	1,835	1,661	5,273	99,680	104,953	7,605
Equity Lines	253	511	640	1,404	65,093	66,497	1,309
Multi-family residential	-	-	2,941	2,941	5,238	8,179	2,941
Commercial real estate owner occupied	3,070	1,038	5,581	9,689	173,381	183,070	7,086
Commercial real estate Non-owner occupied	1,031	577	7,128	8,736	97,107	105,843	13,958
Farmland	6,436	-	188	6,624	53,518	60,142	6,919
Total Real Estate Loans	13,921	3,961	19,556	37,438	539,794	577,232	46,145
Agricultural	-	-	-	-	17,078	17,078	-
Commercial and Industrial	701	386	3,160	4,247	95,161	99,408	3,778
Small Business Administration Loans	828	917	2,715	4,460	16,546	21,006	3,452
Direct finance leases	63	-	591	654	6,089	6,743	591
Consumer loans	520	619	838	1,977	34,147	36,124	2,144
Total Gross Loans and Leases	$ 16,033	$ 5,883	$ 26,860	$ 48,776	$ 708,815	$ 757,591	$ 56,110

[1] Included in Total Financing Receivables

[2] Includes Small Business Administration loans over 90 days past due and still accruing in the amount of $48,000.

Generally, the Company places loans and leases, regardless of class on nonaccrual status and ceases recognizing interest income when the loan has become delinquent more than 90 days and/or when Management determines that the repayment of principal and collection of interest is unlikely. The Company may decide that it is appropriate to continue to accrue interest on certain loans more than 90 days delinquent if they are well-secured by collateral and collection is in process. When a loan is placed on nonaccrual status, any accrued but uncollected interest for the loan is reversed out of interest income in the period in which the loan's status changed. Subsequent payments received from the customer are applied to principal, and no further interest income is recognized until the principal has been paid in full or until circumstances have changed such that payments are again consistently received as contractually required.

The following is a summary of information pertaining to impaired and non-accrual loans (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Impaired loans without a valuation allowance	$ 14,292	$ 49,625
Impaired loans with a valuation allowance	63,870	48,704
Total impaired loans [1]	$ 78,162	$ 98,329
Valuation allowance related to impaired loans	$ 7,125	$ 8,754
Total non-accrual loans	$ 53,094	$ 56,110
Total loans past-due ninety days or more and still accruing	$ -	$ 48

[1] Principal balance only

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Individually impaired loans as of December 31, 2012 were as follows (dollars in thousands):

	Year Ended December 31, 2012				
	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Average Recorded Investment	Interest Income Recognized[3]
With an Allowance Recorded					
Real Estate:					
1-4 family residential construction	$153	$ 153	$ 23	$ 91	$ -
Other Construction/Land	10,313	10,313	1,244	10,755	86
1-4 Family - closed-end	19,218	18,910	955	19,024	401
Equity Lines	1,142	1,142	163	1,144	9
Multifamily residential	-	-	-	-	-
Commercial real estate- owner occupied	5,846	5,585	563	5,666	126
Commercial real estate- non-owner occupied	18,539	17,579	1,230	18,079	481
Farmland	254	254	2	259	-
Total Real Estate	55,465	53,936	4,180	55,018	1,103
Agricultural	28	28	28	28	-
Commercial and Industrial	2,955	2,920	934	3,100	51
Small Business Administration	2,704	2,507	1,038	2,507	53
Direct finance leases	135	135	67	135	-
Consumer loans	4,349	4,344	878	4,493	183
	65,636	63,870	7,125	65,281	1,390
With no Related Allowance Recorded					
Real Estate:					
1-4 family residential construction	$-	$ -	$ -	$ -	$ -
Other Construction/Land	2,335	2,335	-	2,346	-
1-4 Family - closed-end	4,312	4,312	-	4,491	-
Equity Lines	116	116	-	155	1
Multifamily residential	-	-	-	-	-
Commercial real estate- owner occupied	4,298	3,365	-	3,540	-
Commercial real estate- non-owner occupied	390	390	-	421	3

Farmland	1,679	1,679	-	1,686	-
Total Real Estate	13,130	12,197	-	12,639	4
Agricultural	1,008	635	-	1,017	-
Commercial and Industrial	735	736	-	740	-
Small Business Administration	1,008	720	-	720	-
Direct finance leases	-	-	-	-	-
Consumer loans	4	4	-	7	-
	15,885	14,292	-	15,123	4
Total	$81,521	$ 78,162	$ 7,125	$ 80,404	$ 1,394

(1)Contractual principal balance due from customer.

(2)Principal balance on Company's books, less any direct charge offs.

(3)Interest income is recognized on performing balances on a regular accrual basis.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Individually impaired loans as of December 31, 2011 were as follows (dollars in thousands):

	December 31, 2011				
	Unpaid Principal Balance(1)	Recorded Investment(2)	Related Allowance	Average Recorded Investment	Interest Income Recognized(3)
With an Allowance Recorded					
Real Estate:					
1-4 family residential construction	$188	$ 188	$ 13	$ 188	$ -
Other Construction/Land	3,477	2,906	735	2,925	89
1-4 Family - closed-end	8,086	8,057	821	8,071	222
Equity Lines	1,072	1,072	243	1,069	-
Multifamily residential	2,941	2,941	850	2,950	-
Commercial real estate- owner occupied	3,628	3,628	834	3,645	24
Commercial real estate- non-owner occupied	17,454	17,454	1,733	17,842	274
Farmland	-	-	-	-	-
Total Real Estate	36,846	36,246	5,229	36,690	609
Agricultural	-	-	-	-	-
Commercial and Industrial	4,135	4,106	1,481	4,197	24
Small Business Administration	3,902	3,903	1,212	3,903	2
Direct finance leases	591	591	291	591	-
Consumer loans	3,896	3,858	541	3,920	56
	49,370	48,704	8,754	49,301	691
With no Related Allowance Recorded					
Real Estate:					
1-4 family residential construction	$4,784	$ 2,056	$ -	$ 2,069	$ -
Other Construction/Land	11,740	9,081	-	9,326	193
1-4 Family - closed-end	12,467	12,203	-	12,250	101
Equity Lines	307	307	-	318	-
Multifamily residential	-	-	-	-	-
Commercial real estate- owner occupied	6,049	6,030	-	6,136	17
Commercial real estate- non-owner occupied	11,818	11,666	-	12,033	190

Farmland	7,468	6,919	-	6,956	-
Total Real Estate	54,633	48,262	-	49,088	501
Agricultural	-	-	-	-	-
Commercial and Industrial	916	915	-	965	11
Small Business Administration	-	-	-	-	-
Direct finance leases	-	-	-	-	-
Consumer loans	448	448	-	462	11
	55,997	49,625	-	50,515	523
Total	$105,367	$ 98,329	$ 8,754	$ 99,816	$ 1,214

(1)Contractual principal balance due from customer.

(2)Principal balance on Company's books, less any direct charge offs.

(3)Interest income is recognized on performing balances on a regular accrual basis.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Included in loans above are troubled debt restructurings that were classified as impaired. The Company had $3,427,000 and $2,647,000 in commercial loans, $40,639,000 and $55,177,000 in real estate secured loans and $3,976,000 and $3,220,000 in consumer loans, which were modified as troubled debt restructurings and consequently classified as impaired at December 31, 2012 and 2011, respectively.

Additional commitments to existing customers with restructured loans totaled $195,000 and $206,000 at December 31, 2012 and 2011 respectively.

Interest income recognized on impaired loans was $1,394,000, $1,214,000 and $1,575,000 for the years ended December 31, 2012, 2011 and 2010 respectively. There was no interest income recognized on a cash basis on impaired loans for the years ended December 31, 2012, 2011 and 2010 respectively.

The following is a summary of interest income from non-accrual loans in the portfolio at year-end that was not recognized (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Interest that would have been recorded under the loans' original terms	$ 4,084	$ 4,353	$ 3,929
Less gross interest recorded	2,088	1,328	1,219
Foregone interest	$ 1,996	$ 3,025	$ 2,710

Certain loans have been pledged to secure short-term borrowing arrangements (see Note 8). These loans totaled $392,644,000 and $338,868,000 at December 31, 2012 and 2011, respectively.

Salaries and employee benefits totaling $2,745,000, $2,586,000, and $2,376,000 have been deferred as loan and lease origination costs to be amortized over the estimated lives of the related loans and leases for the years ended December 31, 2012, 2011 and 2010, respectively.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

During the periods ended December 31, 2012 and 2011, the terms of certain loans were modified as troubled debt restructurings. Types of modifications applied to these loans, include a reduction of the stated interest rate, a modification of term, an agreement to collect only interest rather than principal and interest for a specified period, or any combination thereof.

The following table presents troubled debt restructurings by type of modification during the period ending December 31, 2012 (dollars in thousands):

	Rate Modification	Term Modification	Interest Only Modification	Rate & Term Modification	Rate & Interest Only Modification	Term & Interest Only Modification	Rate, Term & Interest Only Modification	Total
Troubled Debt Restructurings								
Real Estate:								
Other Construction/Land	$ -	$ 458	$ -	$ 375	$ -	$ -	$ -	$ 833
1-4 family - closed-end	-	313	-	200	-	222	616	1,351
Equity Lines	-	29	-	-	-	-	-	29
Commercial real estate owner occupied	-	1,006	-	1,184	-	-	-	2,190
Commercial real estate Non-owner occupied	-	330	-	60	-	-	-	390
Total Real Estate Loans	-	2,136	-	1,819	-	222	616	4,793
Agricultural products	-	-	-	-	-	-	-	-
Commercial and Industrial	-	625	2	658	-	-	-	1,285
Consumer Loans	-	1,328	-	269	-	-	117	1,714
Small Business Administration loans	-	200	-	475	-	-	-	675

$	-	$	4,289	$	2	$	3,221	$	-	$	222	$	733	$	8,467

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

The following table presents troubled debt restructurings by type of modification during the period ending December 31, 2011 (dollars in thousands):

	Rate Modification	Term Modification	Interest Only Modification	Rate & Term Modification	Rate & Interest Only Modification	Term & Interest Only Modification	Rate, Term & Interest Only Modification	Total
Troubled Debt Restructurings								
Real Estate:								
Other Construction/Land	$ -	$ 555	$ -	$ 754	$ -	$ 6,188	$ -	$7,497
1-4 family - closed-end	-	6,419	-	151	561	48	421	7,600
Equity Lines	-	71	426	-	78	-	-	575
Commercial real estate owner occupied	-	1,893	1,231	297	542	-	-	3,963
Commercial real estate Non-owner occupied	7,400	-	-	1,069	6,420	-	-	14,889
Total Real Estate Loans	7,400	8,938	1,657	2,271	7,601	6,236	421	34,524
Agricultural products	-	-	-	-	-	-	12	12
Commercial and Industrial	19	342	23	1,188	-	384	-	1,956
Consumer Loans	278	495	-	2,069	282	-	85	3,209
Small Business Administration loans	-	621	106	46	-	-	-	773
	$ 7,697	$ 10,396	$ 1,786	$ 5,574	$ 7,883	$ 6,620	$ 518	$40,474

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4LOANS AND LEASES (Continued)

The following tables present loans by class modified as troubled debt restructurings including any subsequent defaults during the period ending December 31, 2012 (dollars in thousands):

	Number of Loans	Pre-Outstanding Recorded Investment	Post-Outstanding Recorded Investment	Reserve Difference[1]
Real Estate:				
Other Construction/Land	10	$ 835	$ 833	$ 48
1-4 family - closed-end	11	1,365	1,351	101
Equity Lines	1	29	29	13
Commercial real estate owner occupied	6	1,857	2,190	(45)
Commercial real estate non-owner occupied	3	390	390	6
Total Real Estate Loans		4,476	4,793	123
Agricultural products	0	-	-	-
Commercial and Industrial	20	1,295	1,285	109
Consumer Loans	37	1,723	1,714	21
Small Business Administration loans	2	668	675	8
		$ 8,162	$ 8,467	$ 261

[1] This represents the increase or (decrease) in the allowance for loans and lease losses reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

Subsequent Defaults		
Number of	Recorded Investment	Charge-Offs

	Loans				
Real Estate:					
Other Construction/Land	0	$	-	$	-
1-4 family - closed-end	1		222		-
Equity Lines	0		-		-
Commercial real estate- owner occupied	1		332		-
Commercial real estate- non owner occupied	0		-		-
Total Real Estate Loans			554		-
Agricultural products	0		-		-
Commercial and Industrial	1		66		66
Consumer Loans	2		115		-
Small Business Administration Loans	0		-		-
		$	735	$	66

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

The following tables present loans by class modified as troubled debt restructurings including any subsequent defaults during the period ending December 31, 2011 (dollars in thousands):

	Number of Loans	Pre-Outstanding Recorded Investment	Post-Outstanding Recorded Investment	Reserve Difference[1]
Real Estate:				
Other Construction/Land	21	$ 7,497	$ 7,497	$ (2)
1-4 family - closed-end	12	7,600	7,600	109
Equity Lines	4	575	575	33
Commercial real estate owner occupied	6	3,963	3,963	(23)
Commercial real estate non-owner occupied	7	15,235	14,889	(375)
Total Real Estate Loans		34,870	34,524	(258)
Agricultural products	1	12	12	-
Commercial and Industrial	21	1,956	1,956	(68)
Consumer Loans	57	3,209	3,209	(130)
Small Business Administration loans	7	775	773	136
		$ 40,822	$ 40,474	$ (320)

[1] This represents the increase or (decrease) in the allowance for loans and lease losses reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

Subsequent Defaults [1]		
Number of Loans	Recorded Investment	Charge-Offs

Real Estate:			
Other Construction/Land	0	$ -	$ -
1-4 family - closed-end	0	-	-
Equity Lines	1	213	-
Commercial real estate- owner occupied	3	2,299	-
Commercial real estate- non owner occupied	0	-	-
Total Real Estate Loans		2,512	-
Agricultural products	0	-	-
Commercial and Industrial	0	-	-
Consumer Loans	2	296	248
Small Business Administration Loans	0	-	-
		$ 2,808	$ 248

(1) Troubled Debt Restructurings within the previous 12 months for which there was a payment default in the periods noted.

In the tables above, the TDRs that subsequently defaulted increased the allowance for loan and lease losses by $31,000 and $240,000 for the years ended December 31, 2012 and 2011 and charge offs resulting from the above defaults were $66,000 and $248,000 respectively. The total allowance for loan and lease losses specifically allocated to the balances that were classified as TDRs during the year ended December 31, 2012 and 2011 is $1,079,000 and $2,199,000 respectively.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

4. LOANS AND LEASES (Continued)

Interest income for all performing loans, regardless of class (Pass, Special Mention, Substandard and Impaired), is recognized on an accrual basis, with interest accrued daily. Costs associated with successful loan originations are netted from loan origination fees, with the net amount (net deferred loan fees) amortized over the contractual life of the loan in interest income. If a loan has scheduled periodic payments, the amortization of the net deferred loan fee is calculated using the effective interest method over the contractual life of the loan. If the loan does not have scheduled payments, such as a line of credit, the net deferred loan fee is recognized as interest income on a straight line basis over the contractual life of the loan. Fees received for loan commitments are recognized as interest income over the term of the commitment. When loans are repaid, any remaining unamortized balances of deferred fees and costs are accounted for through interest income.

Loan Servicing

The Bank originates mortgage loans for sale to investors. During the years ended December 31, 2012, 2011, and 2010, all mortgage loans that were sold by the Bank were sold without retention of related servicing. The Bank's servicing portfolio at December 31, 2012, 2011 and 2010 totaled $2,596,000, $506,000 and $4,778,000, respectively. At December 31, 2012, loans were principally serviced for one investor.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

5. PREMISES AND EQUIPMENT

Premises and equipment at cost consisted of the following (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Land	$ 2,607	$ 2,607
Buildings and improvements	15,720	16,662
Furniture, fixtures and equipment	20,476	22,092
Leasehold improvements	10,496	8,723
	49,299	50,084
Less accumulated depreciation and amortization	27,473	29,375
Construction in progress	4	12
	$ 21,830	$ 20,721

Depreciation and amortization included in occupancy and equipment expense totaled $2,289,000, $2,505,000, and $2,496,000, for the years ended December 31, 2012, 2011 and 2010, respectively.

6. OTHER ASSETS

Other assets consisted of the following (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Accrued interest receivable	$ 5,095	$ 5,368
Deferred tax assets	11,995	11,731
Prepaid taxes	3,775	2,261

Investment in limited partnerships	10,316	9,927
Federal Home Loan Bank stock, at cost	6,019	6,689
Cash surrender value of officer life insurance policies	38,007	37,657
Other	6,262	7,969
	$ 81,469	$ 81,602

The Company has invested in limited partnerships that operate qualified affordable housing projects to receive tax benefits in the form of tax deductions from operating losses and tax credits. The Company accounts for these investments under the cost method and management analyzes these investments annually for potential impairment. The Company has no remaining capital commitments to these partnerships at December 31, 2012.

The Company holds certain equity investments that are not readily marketable securities and thus are classified as "other assets" on the Company's balance sheet. These include investments in Pacific Coast Bankers Bancshares, California Economic Development Lending Initiative, and the Federal Home Loan Bank ("FHLB").

The largest of these is the Company's $6,019,000 investment in FHLB stock, carried at cost. The FHLB requires an equity investment in an amount that is based on a percentage of the Company's borrowing activity at the FHLB. Quarterly, the FHLB assesses the minimum stock requirement based on borrowing activity and membership requirements. Any stock deemed in excess is automatically repurchased by the FHLB at cost.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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7. DEPOSITS

Interest-bearing deposits consisted of the following (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Interest Bearing Demand Deposits	$ 84,655	$ 68,777
NOW	196,771	187,155
Savings	118,547	91,376
Money Market	71,222	76,396
CDAR's, Under $100,000	791	943
CDAR's, $100,000 or more	14,274	17,119
Time, Under $100,000	101,893	106,610
Time, $100,000 or more	218,284	222,847
Brokered Deposits	15,000	15,000
	$ 821,437	$ 786,223

Aggregate annual maturities of time deposits are as follows (dollars in thousands):

Years Ending December 31,	
2013	$331,304
2014	10,660
2015	6,945
2016	582
2017	195
Thereafter	556
	$350,242

Interest expense recognized on interest-bearing deposits consisted of the following (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Interest Bearing Demand Deposits	$ 257	$ 137	$ -
NOW	556	860	1,682
Savings	241	203	174
Money Market	127	506	914
CDAR's, Under $100,000	2	5	48
CDAR's, $100,000 or more	50	194	573
Time, Under $100,000	619	1,001	1,283
Time, $100,000 or more	1,154	1,223	1,237
Brokered Deposits	202	176	210
	$ 3,208	$ 4,305	$ 6,121

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

8. OTHER BORROWING ARRANGEMENTS

Short-term borrowings consisted of the following (dollars in thousands):

	Years Ended December 31,			
	2012		2011	
	Amount	Fixed Rate	Amount	Fixed Rate
Repurchase agreements	$1,419	.60 %	$3,037	.60 %
Overnight Federal Home Loan Bank advances	36,650	.26 %	17,120	.05 %
Federal Home Loan Bank advances	-	-	-	-
	$38,069		$20,157	

The Company had fixed-rate, long-term debt of $5,000,000 with the Federal Home Loan Bank at December 31, 2012 which matures in 2013. The contractual maturity of long-term debt is as follows (dollars in thousands):

Year Ending December 31,	Amount	Weighted Average Rate
2013	$ 5,000	3.93 %

The Company had unsecured lines of credit with its correspondent banks which, in the aggregate, amounted to $55,000,000 at December 31, 2012 and 2011, at interest rates which vary with market conditions. There was $0 outstanding under these lines of credit at December 31, 2012 and December 31, 2011, respectively.

At December 31, 2012, the Company had remaining borrowing capacity with the Federal Home Loan Bank of $124,088,000 secured by government agencies and whole loan collateral.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

9. INCOME TAXES

The provision for income taxes follows (dollars in thousands):

	Year Ended December 31,		
	2012	2011	2010
Federal:			
Current	$ 220	$ 627	$ 1,354
Deferred	(647)	(706)	(1,974)
	(427)	(79)	(620)
State:			
Current	-	818	1,331
Deferred	83	(175)	(945)
	83	643	386
	$ (344)	$ 564	$ (234)

The components of the net deferred tax asset, included in other assets, are as follows (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Deferred tax assets:		
Allowance for loan losses	$ 6,594	$ 7,856
Foreclosed Assets	4,461	3,935
Deferred compensation	3,627	3,373
Accrued reserves	502	1,129
Non Accrual Loans	865	929
Other than temporary impairment charge	576	576
Tax Credit carry forward	2,273	-
Other	185	540
Total deferred tax assets	19,083	18,338

Deferred tax liabilities:		
Premises and equipment	(552)	(718)
Deferred loan costs	(2,152)	(2,118)
Unrealized gain on securities available-for-sale	(2,602)	(2,676)
Other	(1,782)	(1,095)
Total deferred tax liabilities	(7,088)	(6,607)
Net deferred tax assets	$ 11,995	$ 11,731

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

9. INCOME TAXES (Continued)

The expense for income taxes differs from amounts computed by applying the statutory Federal income tax rates to income before income taxes. The significant items comprising these differences consisted of the following (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Income tax expense at Federal statutory rate	$2,666	$2,837	$2,779
Increase (decrease) resulting from:			
State franchise tax expense, net of Federal tax effect	-	540	282
Tax exempt income	(1,388)	(1,330)	(923)
Affordable housing tax credits	(1,639)	(1,605)	(1,642)
Other	17	122	(730)
	$(344)	$564	$(234)
Effective tax rate	(4.4)%	6.8%	(3.3)%

The Company is subject to federal income tax and income tax of the state of California. Our federal income tax returns for the years ended December 31, 2009, 2010 and 2011 are open to audit by the federal authorities and our California state tax returns for the years ended December 31, 2008, 2009, 2010 and 2011 are open to audit by the state authorities.

There were no recorded interest or penalties related to uncertain tax positions as part of income tax for the years ended December 31, 2012, 2011, and 2010, respectively. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next twelve months.

10. SUBORDINATED DEBENTURES

Sierra Statutory Trust II, (“Trust II”) and Sierra Capital Trust III ("Trust III"), (collectively, the “Trusts”) were formed by the Company for the sole purpose of issuing trust preferred securities fully and unconditionally guaranteed by the Company. For financial reporting purposes, the Trusts are not consolidated and the Floating Rate Junior Subordinated Deferrable Interest Debentures (the "Subordinated Debentures") held by the Trusts and issued and guaranteed by the Company are reflected in the Company's consolidated balance sheet in accordance with provisions of FIN 46. Under applicable regulatory guidance, the amount of trust preferred securities that is eligible as Tier 1 capital is limited to twenty-five percent of the company's Tier 1 capital on a pro forma basis. At December 31, 2012, $30,000,000 of trust preferred securities qualified as Tier 1 capital.

During the first quarter of 2004, Sierra Statutory Trust II issued 15,000 Floating Rate Capital Trust Pass-Through Securities (TRUPS II), with a liquidation value of $1,000 per security, for gross proceeds of $15,000,000. The entire proceeds of the issuance were invested by Trust II in $15,464,000 of Subordinated Debentures issued by the Company, with identical maturity, re-pricing and payment terms as the TRUPS II. The Subordinated Debentures, purchased by Trust II, represent the sole assets of the Trust II. Those Subordinated Debentures mature on March 17, 2034, bear a current interest rate of 3.06% (based on 3-month LIBOR plus 2.75%), with re-pricing and payments due quarterly.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

10. SUBORDINATED DEBENTURES (Continued)

Those Subordinated Debentures are currently redeemable by the Company, subject to receipt by the Company of prior approval from the Federal Reserve Bank, on any March 17th, June 17th, September 17th, and December 17th. The redemption price is par plus accrued and unpaid interest, except in the case of redemption under a special event which is defined in the debenture.

The TRUPS II are subject to mandatory redemption to the extent of any early redemption of the related Subordinated Debentures and upon maturity of the Subordinated Debentures on March 17, 2034.

The Trust II has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default on the payment of interest on the Subordinated Debentures. The TRUPS II issued in the offering were sold in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the TRUPS II.

During the second quarter of 2006, Sierra Capital Trust III issued 15,000 Floating Rate Capital Trust Pass-Through Securities (TRUPS III), with a liquidation value of $1,000 per security, for gross proceeds of $15,000,000. The entire proceeds of the issuance were invested by Trust III in $15,464,000 of Subordinated Debentures issued by the Company, with identical maturity, repricing and payment terms as the TRUPS III. The Subordinated Debentures, purchased by Trust III, represent the sole assets of the Trust III. Those Subordinated Debentures mature on September 23, 2036, bear a current interest rate of 1.71% (based on 3-month LIBOR plus 1.40%), with repricing and payments due quarterly.

Those Subordinated Debentures are redeemable by the Company, subject to receipt by the Company of prior approval from the Federal Reserve Bank, on any March 23rd, June 23rd, September 23rd, and December 23rd. The redemption price is par plus accrued and unpaid interest, except in the case of redemption under a special event which is defined in the debenture. The TRUPS III are subject to mandatory redemption to the extent of any early redemption of the related Subordinated Debentures and upon maturity of the Subordinated Debentures on September 23, 2036.

The Trust III has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default on the payment of interest on the Subordinated Debentures. The TRUPS III issued in the offering were sold in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the TRUPS III.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

11. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases certain of its branch facilities under non-cancelable operating leases. Rental expense included in occupancy and equipment expense totaled $1,011,000, $1,167,000 and $1,343,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

Future minimum lease payments on non-cancelable operating leases are as follows:

Years Ending December 31,	
2013	$1,005,000
2014	945,000
2015	903,000
2016	696,000
2017	688,000
Thereafter	4,817,000
	$9,054,000

The Company has options to renew its branch facilities after the initial leases expire. The renewal options range from one to ten years and are not included in the payments reflected above.

Letter of Credit

The Company holds a letter of credit with the Federal Home Loan Bank of San Francisco totaling $55,000,000.The letter of credit is pledged to secure public deposits at December 31, 2012.

Federal Reserve Requirements

Banks are required to maintain reserves with the Federal Reserve Bank equal to a specified percentage of their reservable deposits less vault cash. The reserve balances maintained at the Federal Reserve Bank at December 31, 2012 and 2011 were $38,962,000 and $38,041,000, respectively.

Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and letters of credit as it does for loans included on the balance sheet.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

11. COMMITMENTS AND CONTINGENCIES (Continued)

The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	Years Ended December 31,	
	2012	2011
Fixed-rate commitments to extend credit	$ 53,550	$ 10,150
Variable-rate commitments to extend credit	$ 171,850	$ 144,173
Standby letters of credit	$ 6,690	$ 11,113
Commercial and similar letters of credit	$ 8,539	$ 8,991

Commitments to extend credit consist primarily of unfunded single-family residential and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to extend credit are made at both fixed and variable rates of interest as stated in the table above. Standby letters of credit are issued by the Company to guarantee the performance of a customer to a third party and are made at variable rates of interest. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

Concentration in Real Estate Lending

At December 31, 2012, in management's judgment, a concentration of loans existed in real estate related loans. At that date, approximately 62% of the Company's loans were real estate related. Balances secured by commercial buildings and construction and development loans represented 56% of all real estate loans, while loans secured by non-construction residential properties accounted for 31%, and loans secured by farmland were 13% of real estate loans. Although management believes the loans within these concentrations have no more than the normal risk of collectability, a further decline in the performance of the economy in general or a further decline in real estate values

in the Company's primary market areas, in particular, could have an adverse impact on collectability.

Concentration by Geographic Location

The Company grants commercial, real estate mortgage, real estate construction and consumer loans to customers primarily in the South Central San Joaquin Valley of California, specifically Tulare, Fresno, Kern, Kings and Madera counties. The ability of a substantial portion of the Bank's customers to honor their contracts is dependent on the economy in these areas. Although the Bank's loan portfolio is diversified, there is a relationship in this region between the local agricultural economy and the economic performance of loans made to non-agricultural customers.

Contingencies

The Company is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the consolidated financial position or results of operations of the Company.

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

12. SHAREHOLDERS' EQUITY

Share Repurchase Plan

At December 31, 2012, the Company had a stock repurchase plan which was effective July 1, 2003 and has no expiration date. The repurchase program initially provided that up to 250,000 shares of Sierra Bancorp's common stock could be repurchased by the Company from time to time. That amount was supplemented by 250,000 on May, 19, 2005, another 250,000 shares on March 16, 2006, and an additional 500,000 shares on April 19, 2007.

During the year ended December 31, 2012, the Company did not repurchase any shares, leaving 100,669 shares available for repurchase. Repurchases are generally made in the open market at market prices.

Earnings Per Share

A reconciliation of the numerators and denominators of the basic and diluted earnings per share computations is as follows:

	For the Years Ended December 31,		
	2012	2011	2010
Basic Earnings Per Share			
Net income (dollars in thousands)	$8,185	$7,780	$7,363
Weighted average shares outstanding	14,103,805	14,036,667	12,109,717
Basic earnings per share	$0.58	$0.55	$0.61

Diluted Earnings Per Share

Net income (dollars in thousands)	$8,185	$7,780	$7,363
Weighted average shares outstanding	14,103,805	14,036,667	12,109,717
Effect of dilutive stock options	16,508	48,534	82,628
Weighted average shares outstanding	14,120,313	14,085,201	12,192,345
Diluted earnings per share	$0.58	$0.55	$0.60

Stock Options

In June 1998, Bank of the Sierra adopted the 1998 Stock Option Plan (the "1998 Plan") for which shares were reserved for issuance to employees and directors under incentive and non-statutory agreements. The 1998 Plan was assumed by the Company effective August 10, 2001. Effective May 23, 2007, the 1998 Plan was terminated and no further options may be granted thereunder, but options granted under the 1998 Plan which were outstanding as of the termination date were not affected by this termination. As of December 31, 2012, options granted under the 1998 Plan covering 190,650 shares were still outstanding.

On March 15, 2007 the Board of Directors approved and adopted the Company's 2007 Stock Incentive Plan (the "2007 Plan"), which was approved by the Company's shareholders on May 23, 2007. The 2007 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors, of the Company and its subsidiaries. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, which awards may be granted on such terms and conditions as are established by the Board of Directors or the Compensation Committee in its discretion. We have not issued, nor do we currently have plans to issue, restricted stock awards.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

12. SHAREHOLDERS' EQUITY (Continued)

The maximum number of shares to be issued under the 2007 Plan is 1,500,000 shares of the Company's authorized but unissued common stock, subject to adjustment for stock splits and dividends. This maximum number covers both restricted stock awards and stock options to be granted under the 2007 Plan, and is in addition to options covering 190,650 shares outstanding under the 1998 Plan at December 31, 2012.

All options under the 2007 Plan must be granted at an exercise price of not less than 100% of the fair market value of the stock on the date of grant, and will be exercisable in installments as provided in individual stock option agreements. In the event of a "Change in Control" as defined in the 2007 Plan, all outstanding options there under shall become exercisable in full (subject to certain notification requirements), and shall terminate if not exercised within a specified period of time, unless such options are assumed by the successor corporation or substitute options are granted. Options will terminate in the event an optionee ceases to be employed by or to serve as a director of the Company or its subsidiaries, and the vested portion thereof must be exercised within 30 days after such cessation of employment or service.

A summary of the Company's stock option activity, including options from the 1998 Plan, follows (shares in thousands, except exercise price):

	2012			2011		2010	
	Shares	Weighted Average Exercise Price	Aggregate Intrinsic [1] Value	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	810	$ 14.97		835	$ 14.24	757	$ 15.11
Exercised	(5)	$ 9.45		(125)	$ 6.72	(31)	$ 7.69
Granted	189	$ 10.21		186	$ 10.58	180	$ 10.73
Canceled	(67)	$ 13.08		(86)	$ 10.43	(71)	$ 17.48
Outstanding, end of year	927	$ 14.16	$ 848	810	$ 14.97	835	$ 14.24

Exercisable, end of year [2]	599	$ 16.07	$ 469	504	$ 17.15	553	$ 14.97

[1]The aggregate intrinsic value of stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2012. This amount changes based on changes in the market value of the Company's stock.

[2]The weighted average remaining contractual life of stock options outstanding and exercisable on December 31, 2012 was 7.1 years and 6.2 years, respectively.

Information related to stock options during each year follows:

	Years Ended December 31,		
	2012	2011	2010
Weighted-average grant-date fair value per share	$3.86	$3.79	$4.21
Total intrinsic value of stock options exercised	$9,000	$465,000	$118,000
Total fair value of stock options vested	$517,000	$-	$839,000

Cash received from the exercise of 5,350 shares was $51,000 for the period ended December 31, 2012 with a related tax benefit of $3,000.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

12. SHAREHOLDERS' EQUITY (Continued)

The Company is using the Black-Scholes model to value stock options. According to U.S. GAAP a charge of $487,000, $459,000 and $385,000 is reflected in the Company’s income statements at December 31, 2012, 2011 and 2010 respectively, as pre-tax compensation and directors’ expense related to stock options. The related tax benefit of these options is $56,000, $189,000 and $159,000 for the years ended December 31, 2012, 2011 and 2010 respectively.

Unamortized compensation expense associated with unvested stock options outstanding at December 31, 2012 was $605,000, which will be recognized over the next 4.3 years.

13. REGULATORY MATTERS

The Company and the Bank are subject to certain regulatory requirements administered by the Board of Governors of the Federal Reserve System and the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Each of these components is defined in the regulations. Management believes that the Company and the Bank met all their capital adequacy requirements as of December 31, 2012 and 2011. In addition, as of December 31, 2012 and 2011, notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and leverage capital ratios as set forth below (dollars in thousands):

	Years Ended December 31,			
	2012		2011	
	Capital Amount	Ratio	Capital Amount	Ratio
Leverage Ratio				
Sierra Bancorp and subsidiary	$186,783	13.34%	$187,137	14.11%
Minimum requirement for "Well-Capitalized" institutions	69,993	5.0 %	66,293	5.0 %
Minimum regulatory requirement	55,994	4.0 %	53,035	4.0 %
Bank of the Sierra	$184,024	13.17%	$178,918	13.53%
Minimum requirement for "Well-Capitalized" institutions	69,866	5.0 %	66,122	5.0 %
Minimum regulatory requirement	55,893	4.0 %	52,897	4.0 %

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

13. REGULATORY MATTERS (Continued)

	Year Ended December 31,			
	2012		2011	
	Capital Amount	Ratio	Capital Amount	Ratio
Tier 1 Risk-Based Capital Ratio				
Sierra Bancorp and subsidiary	$183,783	18.11%	$187,137	20.46%
Minimum requirement for "Well-Capitalized" institutions	61,878	6.0 %	54,885	6.0 %
Minimum regulatory requirement	41,252	4.0 %	36,590	4.0 %
Bank of the Sierra	$184,024	17.88%	$178,918	19.63%
Minimum requirement for "Well-Capitalized" institutions	61,737	6.0 %	54,697	6.0 %
Minimum regulatory requirement	41,158	4.0 %	36,465	4.0 %
Total Risk-Based Capital Ratio				
Sierra Bancorp and subsidiary	$199,700	19.36%	$198,651	21.72%
Minimum requirement for "Well-Capitalized" institutions	103,131	10.0 %	91,476	10.0 %
Minimum regulatory requirement	82,504	8.0 %	73,180	8.0 %
Bank of the Sierra	$196,912	19.14%	$190,393	20.89%
Minimum requirement for "Well-Capitalized" institutions	102,895	10.0 %	91,161	10.0 %
Minimum regulatory requirement	82,316	8.0 %	72,929	8.0 %

Under current rules of the Federal Reserve Board, qualified trust preferred securities are one of several “restricted” core capital elements which may be included in Tier 1 capital in an aggregate amount limited to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. Amounts of restricted core capital elements in excess of these limits generally may be included in tier 2 capital. Since the Company had less than $15 billion in assets at December 31, 2012, under the Dodd-Frank Act, the Company will be able to continue to include its existing trust preferred securities in Tier 1 Capital to the extent permitted by FRB guidelines. However, the treatment of the Company’s trust preferred securities will change in the near future if proposed regulations to conform to Basel III requirements are adopted.

Dividend Restrictions

The Company's ability to pay cash dividends is dependent on dividends paid to it by the Bank, and is also limited by state corporation law. The California General Corporation Law allows a California corporation to pay dividends if the Company’s retained earnings equal at least the amount of the proposed dividend. If the Company does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if immediately after giving effect to the dividend the sum of the company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities.

Dividends from the Bank to the Company are restricted under California law to the lesser of the Bank’s retained earnings or the Bank’s net income for the latest three fiscal years, less dividends previously declared during that period, or, with the approval of the Department of Financial Institutions, to the greater of the retained earnings of the Bank, the net income of the Bank for its last fiscal year, or the net income of the Bank for its current fiscal year. As of December 31, 2012, the maximum amount available for dividend distribution under this restriction was approximately $26,886,000.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

14. BENEFIT PLANS

Salary Continuation Agreements, Directors' Retirement and Officer Supplemental Life Insurance Plans

The Company has entered into salary continuation agreements with its executive officers, and has established retirement plans for qualifying members of the Board of Directors. The plans provide for annual benefits for up to fifteen years after retirement or death. The benefit obligation under these plans totaled $4,747,000 and $4,538,000, and was fully accrued for the years ended December 31, 2012 and 2011, respectively. The expense recognized under these arrangements totaled $292,000, $403,000, and $510,000 for the years ended December 31, 2012, 2011 and 2010, respectively. Salary continuation benefits paid to former directors or executives of the Company or their beneficiaries totaled $83,000 for each of the years ended December 31, 2012, 2011 and 2010. The Company also provides benefits to former executives of Sierra National Bank under salary continuation plans that were in effect at the time Sierra National Bank was merged into Bank of the Sierra. The benefit obligation under these plans totaled $145,000, $197,000 and $245,000, and was fully accrued for the years ended December 31, 2012, 2011, and 2010, respectively. Benefits paid to former executives of SNB under this plan totaled $67,000, for each of the years ended December 31, 2012, 2011, and 2010, respectively. Certain officers of the Company have supplemental life insurance policies with death benefits available to the officers' beneficiaries.

In connection with these plans, the Company has purchased, or acquired through the merger, single premium life insurance policies with cash surrender values totaling $34,762,000 and $34,937,000 at December 31, 2012 and 2011, respectively. On the consolidated balance sheet, the cash surrender values are included in other assets.

Officer and Director Deferred Compensation Plan

The Company has established a deferred compensation plan for certain members of the management group and a deferred fee plan for directors for the purpose of providing the opportunity for participants to defer compensation. The Company bears the costs for the plan’s administration and the interest earned on participant deferrals. The related administrative expense was not material for the years ended December 31, 2012, 2011 and 2010. In connection with this plan, life insurance policies with cash surrender values totaling $3,245,000 and $2,720,000 at December 31, 2012

and 2011, respectively, are included on the consolidated balance sheet in other assets.

401(k) Savings Plan

The 401(k) savings plan (the "Plan") allows participants to defer, on a pre-tax basis, up to 15% of their salary (subject to Internal Revenue Service limitations) and accumulate tax-deferred earnings as a retirement fund. The Bank may make a discretionary contribution to match a specified percentage of the first 6% of the participants' contributions annually. The amount of the matching contribution was 50% for each of the years ended December 31, 2012, 2011 and 2010. The matching contribution is discretionary; vests over a period of five years from the participants’ hire date and is subject to the approval of the Board of Directors. The Company contributed $302,000, $304,000 and $286,000 to the Plan in 2012, 2011 and 2010, respectively.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

15. NON-INTEREST REVENUE

The major grouping of non-interest revenue on the consolidated income statements includes several specific items: service charges on deposit accounts, gain on sale of loans, credit card fees, check card fees, (loss) gain on sales and calls of investment securities available for sale, and increase in cash surrender value of life insurance.

Non-interest revenue also includes one general category of other income of which the following are major components (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Included in other income:			
Loss on limited partnerships	$ (395)	$ (885)	$ (808)
Dividends on Equity Investments	67	26	52
Rental income on leases	102	173	570
Other	2,134	1,842	1,457
Total other non-interest revenue	$ 1,908	$ 1,156	$ 1,271

16. OTHER OPERATING EXPENSE

Other expense consisted of the following (dollars in thousands):

	Year Ended December 31,		
	2012	2011	2010
Professional fees	$ 3,454	$ 3,941	$ 5,018
Data processing	1,807	1,523	1,737

Advertising and promotion	1,771	2,051	1,979
Deposit services	2,266	2,516	2,708
Stationery and supplies	738	705	715
Telephone and data communication	1,549	1,291	1,156
Loan and credit card processing	419	1,082	765
Foreclosed assets expense	4,914	5,226	7,572
Postage	718	576	558
Other	1,905	1,267	1,521
Total other non-interest expense	$19,541	$20,178	$23,729

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

17. RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into loans with related parties, including executive officers and directors. These loans are made with substantially the same terms, including rates and collateral, as loans to unrelated parties. The following is a summary of the aggregate activity involving related party borrowers (dollars in thousands):

	Years Ended December 31,		
	2012	2011	2010
Balance, beginning of year	$2,471	$3,465	$3,104
Disbursements	625	773	2,343
Amounts repaid	(2,467)	(1,767)	(1,982)
Decreased	-	-	-
Balance, end of year	$629	$2,471	$3,465
Undisbursed commitments to related parties	$330	$472	$1,433

Deposits from related parties held by the Bank at December 31, 2012 and 2011 amounted to $9,012,000 and $6,665,000 respectively.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

18.FAIR VALUE

Fair value is defined by U.S. GAAP as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

§ Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

§ Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

§ Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

18. FAIR VALUE (Continued)

The Company used the following methods and significant assumptions to estimate fair values for each category of financial asset noted below:

Securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry, to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

Collateral Dependent Impaired loans: A specific loss allowance is created for collateral dependent impaired loans, representing the difference between the face value of the loan and its current appraised value less estimated disposition costs.

Foreclosed assets: Repossessed real estate (OREO) and other assets such as mobile homes are acquired at fair value, which is the appraised value less expected disposition costs, ranging from 5% to 15% depending on the specific property. Foreclosed assets are periodically measured for impairment using updated appraisals. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

18.FAIR VALUE (Continued)

Assets and liabilities measured at fair value on a recurring basis, including financial liabilities for which the Company has elected the fair value option, are summarized below (dollars in thousands):

	Fair Value Measurements at December 31, 2012, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Investment Securities					
U.S. Government agencies	$ -	$ 2,973	$ -	$ 2,973	$ -
Obligations of states and political subdivisions	-	73,986	-	73,986	-
U.S. Government agencies collateralized by mortgage obligations	-	301,389	-	301,389	-
Other Securities	1,809	31	-	1,840	-
Total available-for-sale securities	$ 1,809	$ 378,379	$ -	$ 380,188	$ -

	Fair Value Measurements at December 31, 2011, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Investment Securities					
U.S. Government agencies	$ -	$ 2,026	$ -	$ 2,026	$ -

Obligations of states and political subdivisions	-	71,340	-	71,340	-
U.S. Government agencies collateralized by mortgage obligations	-	331,758	-	331,758	-
Other Securities	1,347	-	-	1,347	(1,370)
Total available-for-sale securities	$ 1,347	$ 405,124	$ -	$ 406,471	$ (1,370)

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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18. FAIR VALUE (Continued)

Assets and liabilities measured at fair market value on a non-recurring basis are summarized below (dollars in thousands):

	Year Ended December 31, 2012			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Collateral Dependent Impaired Loans	$ -	$ 27,449	$ -	$27,449
Foreclosed Assets	$-	$ 19,754	$ -	$19,754

	Year Ended December 31, 2011			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Collateral Dependent Impaired Loans	$ -	$ 11,016	$ 285	$11,301
Foreclosed Assets	$-	$ 14,777	$ 587	$15,364

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Disclosures include estimated fair values 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.

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 value of its financial instruments at December 31, 2012 and 2011:

Cash and cash equivalents and short-term borrowings: For cash and cash equivalents and short-term borrowings, the carrying amount is estimated to be fair value.

Investment securities: For investment securities, fair values are based on quoted market prices, where available. 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.

Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated using discounted cash flow analyses, using interest rates being offered at each reporting date for loans and leases with similar terms to borrowers of comparable creditworthiness. Fair values of loans held for sale are estimated using quoted market prices for similar loans or the amount the purchasers have committed to purchase the loan. The carrying amount of accrued interest receivable approximates its fair value.

Cash surrender value of life insurance policies: The fair values are based on current cash surrender values at each reporting date provided by the insurers.

Investment in limited partnerships: The fair values of the investments in WNC Institutional Tax Credit Fund Limited Partnerships are estimated using quarterly indications of value provided by the general partner.

Other investments: Included in other assets are certain long-term investments carried at cost, which approximates estimated fair value.

Deposits: The fair values for demand deposits and other non-maturity deposits are, by definition, equal to the amount payable on demand at the reporting date represented by their carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis using interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings: The carrying amounts of federal funds purchased, overnight FHLB advances, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Long-term borrowings: The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Subordinated debentures: The fair value of subordinated debentures was determined based on the current market value for like kind instruments of a similar maturity and structure.

Limited partnership capital commitments: The fair value of the capital commitments to the WNC Institutional Tax Credit Fund Limited Partnerships are estimated using a discounted cash flow analysis using rates of return currently available for similar instruments.

Commitments to extend credit and letters of credit: Commitments to extend credit are primarily for adjustable rate loans. For these commitments, there are no differences between the committed amounts and their fair values. Commitments to fund fixed rate loans and letters of credit are at rates which approximate fair value at each reporting date.

Carrying amount and estimated fair values of financial instruments were as follows (dollars in thousands):

	Year Ended December 31, 2012				
		Estimated Fair Value			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial Assets:					
Cash and cash equivalents	$61,818	$61,818	$ -	$ -	$61,818
Investment securities available for sale	380,188	1,809	378,379	-	380,188

Loans and leases held for investment	839,629	-	873,309	-	873,309
Collateral dependent impaired loans	27,449	-	27,449	-	27,449
Loans held-for-sale	210	210	-	-	210
Cash surrender value of life insurance policies	38,007	-	38,007	-	38,007
Other Investments	6,370	-	6,370	-	6,370
Investment in Limited Partnership	10,316	-	10,316	-	10,316
Accrued interest receivable	5,095	-	5,095	-	5,095
Financial Liabilities:					
Deposits:					
Noninterest-bearing	$352,597	$352,597	$ -	$ -	$352,597
Interest-bearing	821,437	-	821,911	-	821,911
Fed Funds Purchased and Repurchase Agreements	1,419	-	1,419	-	1,419
Short-term borrowings	36,650	-	36,650	-	36,650
Long-term borrowings	5,000	-	5,038	-	5,038
Subordinated debentures	30,928	-	12,141	-	12,141
Limited partnership capital commitment	962	-	962	-	962
Accrued Interest Payable	304	-	304	-	304

	Notional Amount
Off-balance-sheet financial instruments:	
Commitments to extend credit	$225,400
Standby letters of credit	6,690
Commercial lines of credit	8,539

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Carrying amount and estimated fair values of financial instruments were as follows (dollars in thousands):

	Year Ended December 31, 2011				
		Estimated Fair Value			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial Assets:					
Cash and cash equivalents	$63,036	$63,036	$ -	$ -	$63,036
Investment securities available for sale	406,471	1,347	405,124	-	406,471
Loans and leases held for investment	729,628	-	771,192	-	771,192
Collateral dependent impaired loans	11,301	-	11,016	285	11,301
Loans held-for-sale	1,354	1,354	-	-	1,354
Cash surrender value of life insurance policies	37,657	-	37,657	-	37,657
Other Investments	7,040	-	7,040	-	7,040
Investment in Limited Partnership	9,927	-	9,927	-	9,927
Accrued interest receivable	5,368	-	5,368	-	5,368
Financial Liabilities:					
Deposits:					
Noninterest-bearing	$300,045	$300,045	$ -	$ -	$300,045
Interest-bearing	786,223	-	702,270	-	702,270
Fed Funds Purchased and Repurchase Agreements	3,037	-	3,037	-	3,037
Short-term borrowings	17,120	-	17,120	-	17,120
Long-term borrowings	15,000	-	15,287	-	15,287
Subordinated debentures	30,928	-	12,262	-	12,262
Limited partnership capital commitment	353	-	353	-	353

Accrued Interest Payable	514	-	514	-	514

	Notional Amount
Off-balance-sheet financial instruments:	
Commitments to extend credit	154,323
Standby letters of credit	11,113
Commercial lines of credit	8,991

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS

BALANCE SHEETS

Years Ended December 31, 2012 and 2011

(dollars in thousands)

	2012	2011
ASSETS		
Cash and due from banks	$1,712	$5,395
Investments in bank subsidiary	200,497	191,135
Investment in Trust subsidiaries	928	928
Investment in other securities	1,809	1,330
Other assets	263	847
Total Assets	$205,209	$199,635
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Other liabilities	$390	$143
Subordinated debentures	30,928	30,928
Total liabilities	31,318	31,071
Shareholders' equity:		
Common stock	67,043	66,542
Retained Earnings	103,128	98,174
Accumulated other comprehensive income, net of taxes	3,720	3,848
Total shareholders' equity	173,891	168,564
Total liabilities and shareholders' equity	$205,209	$199,635

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)

STATEMENTS OF INCOME

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands)

	2012	2011	2010
Income:			
Other-than-temporary impairment losses on equity securities	$-	$(1,370)	$-
Other operating income	10	21	-
Total Income	10	(1,349)	-
Expense			
Salaries and employee benefits	254	206	170
Other expenses	1,365	1,388	1,326
Total expenses	1,619	1,594	1,496
Loss before income taxes	(1,609)	(2,943)	(1,496)
Income tax benefit	(663)	(1,212)	(615)
(Loss)/Income before equity in undistributed income of subsidiary	(946)	(1,731)	(881)
Equity in undistributed income of subsidiary	9,131	9,511	8,244
Net income	$8,185	$7,780	$7,363

SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)

STATEMENTS OF CASH FLOWS

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands)

	2012	2011	2010
Cash flows from operating activities:			
Net Income	$8,185	$7,780	$7,363
Adjustments to reconcile net income to net cash provided by operating activities:			
Undistributed net income of subsidiary	(9,131)	(9,511)	(8,244)
Other-than-temporary impairment loss	-	1,370	-
Increase in other assets	583	(140)	(585)
Increase/(decrease) in other liabilities	50	73	(108)
Tax benefit from equity based compensation	(36)	109	19
Net cash used in operating activities	(349)	(319)	(1,555)
Cash flows from investing activities:			
Payments for investments in and advances to Subsidiaries	-	-	(14,000)
Net cash provided by/(used in) investing activities	-	-	(14,000)
Cash flows from financing activities:			
(Expense)/Proceeds from the issuance of common stock	-	(23)	21,864
Stock options exercised	51	867	242
Dividends paid	(3,385)	(3,368)	(2,935)
Net cash (used in)/provided by financing activities	(3,334)	(2,524)	19,171

Net (decrease)/increase in cash and cash equivalents	(3,683)	(2,843)	3,616
Cash and cash equivalents, beginning of year	5,395	8,238	4,622
Cash and cash equivalents, end of year	$1,712	$5,395	$8,238

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SIERRA BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

21. CONDENSED QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following table sets forth the Company's results of operations for the four quarters of 2012 and 2011 and is unaudited. In management's opinion, the results of operations reflect all adjustments (which include only recurring adjustments) necessary to present fairly the condensed results for such periods.

	2012 Quarter Ended			
	December 31,	September 30,	June 30,	March 31,
Interest income	$13,389	$ 14,192	$13,612	$ 13,709
Interest expense	973	1,063	1,064	1,221
Net interest income	12,416	13,129	12,548	12,488
Provision for loan and lease losses	3,600	4,700	3,160	2,750
Non-interest income	5,521	4,381	4,121	4,103
Non-interest expense	12,637	11,496	10,482	12,041
Net income before taxes	1,700	1,314	3,027	1,800
Provision for taxes	(398)	(321)	454	(79)
Net income	$2,098	$ 1,635	$2,573	$ 1,879
Diluted earnings per share	$.15	$ .12	$.18	$ .13
Cash dividend per share	$.06	$ .06	$.06	$ .06

	2011 Quarter Ended			
	December 31,	September 30,	June 30,	March 31,
Interest income	$14,304	$ 14,939	$14,949	$ 14,422
Interest expense	1,367	1,392	1,452	1,446
Net interest income	12,937	13,547	13,497	12,976
Provision for loan and lease losses	2,400	3,000	3,000	3,600
Non-interest income	4,093	3,599	3,767	3,533
Non-interest expense	13,299	10,798	11,849	11,659
Net income before taxes	1,331	3,348	2,415	1,250

Provision for taxes	(210)	822	231	(279)
Net income	$1,541	$ 2,526	$2,184	$ 1,529
Diluted earnings per share	$.10	$ .18	$.16	$ .11
Cash dividend per share	$.06	$ .06	$.06	$ .06

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Item 9. Changes in and Disagreements with Accountants on Accounting And Financial Disclosure

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company's Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13(a)–15(e) as of the end of the period covered by this report (the "Evaluation Date") have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this annual report was being prepared.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized, and reported within the time periods specified by the SEC.

Management's Report on Internal Control over Financial Reporting

Management of the Company is responsible for the preparation, integrity, and reliability of the consolidated financial statements and related financial information contained in this annual report. The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on judgments and estimates of management.

Management has established and is responsible for maintaining effective internal control over financial reporting. The Company's internal control over financial reporting includes those policies and procedures that:

(i)

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time. The system contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2012. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control - Integrated Framework" published by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2012.

Management is responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations. Management assessed compliance by the Company’s insured financial institution, Bank of the Sierra, with the designated laws and regulations relating to safety and soundness. Based on this assessment, management believes that Bank of the Sierra complied, in all significant respects, with the designated laws and regulations related to safety and soundness for the year ended December 31, 2012.

Our assessment of the effectiveness of the Company’s internal control over financial reporting as of December 31, 2012 has been audited by Vavrinek, Trine, Day & Co., LLP, an independent registered public accounting firm, as stated in their report appearing below.

Changes in Internal Control

There were no significant changes in the Company’s internal control over financial reporting or in other factors in the fourth quarter of 2012 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Sierra Bancorp and Subsidiary

Porterville, California

We have audited Sierra and Subsidiary's (the Company) internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in conformity with U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that (1) in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and the receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board, the consolidated balance sheets of the Company as of December 31, 2012 and 2011 and the related consolidated statements of operations, comprehensive income, shareholders' equity and cash flows for the three years in the period ended December 31, 2012, and our report dated March 14, 2013 expressed an unqualified opinion on those financial statements.

/s/ Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California

March 14, 2013

ITEM 9B. OTHER INFORMATION.

None.

PART III

Item 10. Directors, Executive Officers AND CORPORATE GOVERNANCE

The information required to be furnished pursuant to this item with respect to Directors and Executive Officers of the Company will be set forth under the caption "Election of Directors" in the Company's proxy statement for the 2013 Annual Meeting of Shareholders (the "Proxy Statement"), which the Company will file with the SEC within 120 days after the close of the Company's 2012 fiscal year in accordance with SEC Regulation 14A under the Securities Exchange Act of 1934. Such information is hereby incorporated by reference.

The information required to be furnished pursuant to this item with respect to compliance with Section 16(a) of the Exchange Act will be set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement, and is incorporated herein by reference.

The information required to be furnished pursuant to this item with respect to the Company's Code of Ethics and corporate governance matters will be set forth under the caption "Corporate Governance" in the Proxy Statement, and is incorporated herein by reference.

Item 11. Executive Compensation

The information required to be furnished pursuant to this item will be set forth under the captions "Executive Officer and Director Compensation" and "Compensation Discussion and Analysis" in the Proxy Statement, and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management AND RELATED SHAREHOLDER MATTERS

Securities Authorized for Issuance under Equity Compensation Plans

The information required by Item 12 with respect to securities authorized for issuance under equity compensation plans is set forth under “Item 5 – Market for Registrant’s Common Equity and Issuer Repurchases of Equity Securities” above.

Other Information Concerning Security Ownership of Certain Beneficial Owners and Management

The remainder of the information required by Item 12 will be set forth under the captions “Security Ownership of Certain Beneficial Owners and Management” and “Election of Directors” in the Proxy Statement, and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions AND DIRECTOR INDEPENDENCE

The information required to be furnished pursuant to this item will be set forth under the captions “Related Party Transactions” and “Corporate Governance – Director Independence” in the Proxy Statement, and is incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTING FEES and SERVICES

The information required to be furnished pursuant to this item will be set forth under the caption "Ratification of Appointment of Independent Registered Public Accounting Firm – Fees" in the Proxy Statement, and is incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) **Exhibits**

Exhibit #	Description
3.1	Restated Articles of Incorporation of Sierra Bancorp (1)
3.2	Amended and Restated By-laws of Sierra Bancorp (2)
10.1	1998 Stock Option Plan (3)
10.2	Salary Continuation Agreement for Kenneth R. Taylor (4)
10.3	Salary Continuation Agreement for James C. Holly (4)
10.4	Salary Continuation Agreement and Split Dollar Agreement for James F. Gardunio (5)
10.5	Split Dollar Agreement for Kenneth R. Taylor (6)
10.6	Split Dollar Agreement and Amendment thereto for James C. Holly (6)
10.7	Director Retirement Agreement and Split dollar Agreement for Vincent Jurkovich (6)
10.8	Director Retirement Agreement and Split dollar Agreement for Robert Fields (6)
10.9	Director Retirement Agreement and Split dollar Agreement for Gordon Woods (6)
10.10	Director Retirement Agreement and Split dollar Agreement for Morris Tharp (6)
10.11	Director Retirement Agreement and Split dollar Agreement for Albert Berra (6)
10.12	401 Plus Non-Qualified Deferred Compensation Plan (6)
10.13	Indenture dated as of March 17, 2004 between U.S. Bank N.A., as Trustee, and Sierra Bancorp, as Issuer (7)
10.14	Amended and Restated Declaration of Trust of Sierra Statutory Trust II, dated as of March 17, 2004 (7)
10.15	Guarantee Agreement between Sierra Bancorp and U.S. Bank National Association dated as of March 17, 2004 (7)
10.16	Indenture dated as of June 15, 2006 between Wilmington Trust Co., as Trustee, and Sierra Bancorp, as Issuer (8)
10.17	Amended and Restated Declaration of Trust of Sierra Capital Trust III, dated as of June 15, 2006 (8)
10.18	Guarantee Agreement between Sierra Bancorp and Wilmington Trust Company dated as of June 15, 2006 (8)
10.19	2007 Stock Incentive Plan (9)
10.20	Sample Retirement Agreement Entered into with Each Non-Employee Director Effective January 1, 2007 (10)
10.21	Salary Continuation Agreement for Kevin J. McPhaill (10)
10.22	First Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (10)
11	Statement of Computation of Per Share Earnings (11)
21	Subsidiaries of Sierra Bancorp (12)
23	Consent of Vavrinek, Trine, Day & Co., LLP
31.1	Certification of Chief Executive Officer (Section 302 Certification)
31.2	Certification of Chief Financial Officer (Section 302 Certification)
32	Certification of Periodic Financial Report (Section 906 Certification)

(1) Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.
(2) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.
(3) Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission ("SEC") (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.
(4) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.
(5) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.
(6) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.
(7) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
(8) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.
(9) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
(10) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
(11) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.
(12) Filed as Exhibit 21 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference

(b) **Financial Statement Schedules**

Schedules to the financial statements are omitted because the required information is not applicable or because the required information is presented in the Company's Consolidated Financial Statements or related notes.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 14, 2013 SIERRA BANCORP,
a California corporation

By: /s/ James C. Holly
James C. Holly
President &
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Kenneth R. Taylor
Kenneth R. Taylor
Executive Vice President &
Chief Financial Officer
(Principal Financial and Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Albert L. Berra Albert L. Berra	Director	March 14, 2013
/s/ Robert L. Fields Robert L. Fields	Director	March 14, 2013
/s/ James C. Holly James C. Holly	President, Chief Executive Officer, & Director (Principal Executive Officer)	March 14, 2013
/s/ Vincent L. Jurkovich Vincent L. Jurkovich	Director	March 14, 2013
/s/ Lynda B. Scearcy Lynda B. Scearcy	Director	March 14, 2013

/s/ Morris A. Tharp Morris A. Tharp	Chairman of the Board	March 14, 2013
/s/ Gordon T. Woods Gordon T. Woods	Director	March 14, 2013
/s/ Kenneth R. Taylor Kenneth R. Taylor	Executive Vice President & Chief Financial Officer (Principal Financial and Principal Accounting Officer)	March 14, 2013