SIERRA BANCORP
Form 10-Q
November 08, 2007
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of Registrant as specified in its charter)

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

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant s telephone number, including area code)

Not Applicable

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨

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

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

Common stock, no par value, 9,716,841 shares outstanding as of October 31, 2007

FORM 10-Q

Table of Contents

Table of Contents

PART I FINANCIAL INFORMATION

Item 1

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

	September 30, 2007 (unaudited)	December 31, 2006 (audited)
ASSETS		
Cash and due from banks	$ 38,037	$ 52,597
Interest-bearing deposits in other banks	129	128
Federal funds sold		6,290
Total Cash & Cash Equivalents	38,166	59,015
Investment securities available for sale	184,557	190,272
Loans and leases:		
Gross loans and leases	906,565	888,008
Allowance for loan and lease losses	(12,195)	(11,579)
Deferred loan and lease fees, net	(3,242)	(3,618)
Net Loans and Leases	891,128	872,811
Premises and equipment, net	18,612	17,978
Other assets	75,614	74,998
TOTAL ASSETS	$1,208,077	$1,215,074
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Deposits:		
Non-interest bearing	$ 231,831	$ 281,024
Interest bearing	654,748	587,421
Total Deposits	886,579	868,445
Federal funds purchased and repurchase agreements	22,923	51,003
Short-term borrowings	145,700	131,400
Long-term borrowings	5,000	27,000
Other liabilities	18,322	15,927
Junior subordinated debentures	30,928	30,928
TOTAL LIABILITIES	1,109,452	1,124,703
SHAREHOLDERS EQUITY		
Common stock, no par value; 24,000,000 shares authorized; 9,719,919 and 9,749,913 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	19,243	16,102
Retained earnings	80,829	75,928
Accumulated other comprehensive income	(1,447)	(1,659)
TOTAL SHAREHOLDER S EQUITY	98,625	90,371

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 1,208,077	$ 1,215,074

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

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

	For the Three-Month Period Ended September 30, 2007	2006	For the Nine-Month Period Ended September 30, 2007	2006
Interest income:				
Interest and fees on loans	$ 20,098	$ 19,046	$ 59,906	$ 52,718
Interest on investment securities:				
Taxable	1,512	1,558	4,588	4,763
Tax-exempt	559	519	1,664	1,509
Interest on Federal funds sold and interest-bearing deposits	21	8	39	25
Total interest income	22,190	21,131	66,197	59,015
Interest expense:				
Interest on deposits	5,968	4,314	16,935	10,879
Interest on short-term borrowings	1,542	1,686	4,925	3,500
Interest on long-term borrowings	42	212	308	768
Interest on manditorily redeemable trust preferred securities	576	971	1,705	2,320
Total interest expense	8,128	7,183	23,873	17,467
Net Interest Income	14,062	13,948	42,324	41,548
Provision for loan losses	700	1,051	2,302	3,150
Net Interest Income after Provision for Loan Losses	13,362	12,897	40,022	38,398
Non-interest revenue:				
Service charges on deposit accounts	2,105	1,498	5,434	4,493
Gains on investment securities available-for-sale	2	9	14	9
Other	1,259	1,301	5,654	3,721
Total other operating income	3,366	2,808	11,102	8,223
Other operating expense:				
Salaries and employee benefits	4,045	4,083	13,143	12,194
Occupancy expense	1,701	1,703	4,808	4,912
Other	3,096	2,505	8,841	7,745
Total other operating expenses	8,842	8,291	26,792	24,851
Income before income taxes	7,886	7,414	24,332	21,770
Provision for income taxes	2,616	2,512	8,254	7,319
Net Income	$ 5,270	$ 4,902	$ 16,078	$ 14,451
PER SHARE DATA				
Book value	$ 10.15	$ 9.08	$ 10.15	$ 9.08
Cash dividends	$ 0.16	$ 0.14	$ 0.46	$ 0.40
Earnings per share basic	$ 0.54	$ 0.50	$ 1.66	$ 1.48
Earnings per share diluted	$ 0.53	$ 0.48	$ 1.60	$ 1.41
Average shares outstanding, basic	9,672,247	9,773,097	9,713,097	9,763,707
Average shares outstanding, diluted	10,008,463	10,288,817	10,076,118	10,276,581

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

4

Table of Contents

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Nine Months Ended September 30, 2007	2006
Cash Flows from Operating Activities		
Net income	$ 16,078	$ 14,451
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on investment securities	$ (14)	$ (9)
Gain on sales of loans	(1,619)	
Loss on disposal of fixed assets	23	
(Gain) Loss on sale of foreclosed assets	(7)	18
Writedown on foreclosed assets		133
Share-based compensation expense	245	261
Provision for loan losses	2,302	3,150
Depreciation and amortization	2,413	2,598
Net amortization on securities premiums and discounts	187	535
(Increase) Decrease in unearned net loan fees	(376)	1,000
Increase in cash surrender value of life insurance policies	(940)	(578)
Proceeds from sales of loans held for sale	1,167	
Proceeds from sales of loan portfolio	11,952	
Originations of loans held for sale	(1,152)	
Decrease (Increase) in interest receivable and other assets	60	(5,986)
Increase in other liabilities	3,966	3,577
Excess tax benefit from share-based payment arrangements	(1,555)	(868)
Net cash provided by operating activities	32,730	18,282
Cash Flows from Investing Activities		
Maturities of securities available for sale	3,204	4,234
Proceeds from sales/calls of securities available for sale	2,506	925
Purchases of securities available for sale	(17,873)	(22,638)
Principal paydowns on securities available for sale	18,069	20,282
Increase in loans receivable, net	(31,067)	(128,765)
Purchases of premises and equipment, net	(2,558)	(3,696)
Proceeds from sales of foreclosed assets	66	399
Net cash used in investing activities	(27,653)	(129,259)
Cash Flows from Financing Activities		
Increase in deposits	18,134	15,323
(Decrease) Increase in federal funds purchased	(25,000)	25,000
(Decrease) Increase in borrowed funds	(7,700)	56,530
Decrease in repurchase agreements	(3,080)	(4,820)
Proceeds from issuance of subordinated debentures		15,464
Cash dividends paid	(4,466)	(3,907)
Stock repurchased	(6,992)	(2,642)
Stock options exercised	1,623	1,499
Excess tax benefit from share-based payment arrangements	1,555	868
Net cash (used in) provided by financing activities	(25,926)	103,315

Decrease in cash and due from banks	(20,849)	(7,662)
Cash and Cash Equivalents		
Beginning of period	59,015	50,147
End of period	$ 38,166	$ 42,485

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

5

Table of Contents

SIERRA BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2007

Note 1 The Business of Sierra Bancorp

Sierra Bancorp (the Company), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. 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 main source of income is dividends from the Bank, but the Company intends to explore supplemental sources of income in the future. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, the cost of servicing debt, audit costs, and shareholder expenses will generally be paid from dividends remitted to the Company by the Bank.

At the present time, the Company s only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities. Pursuant to FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the Company include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California. It was incorporated in September 1977, opened for business in January 1978, and has grown to be the largest independent bank headquartered in the South San Joaquin Valley. The Bank is an independent multi-community bank that offers a full range of retail and commercial banking services primarily in the central and southern sections of the San Joaquin Valley. On the southern end, our footprint extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. We currently operate 21 full service branch offices throughout this geographic footprint. The Bank s two newest branches opened in Delano in March 2007 and Bakersfield in February 2006. Our next branch is expected to be another branch in the city of Bakersfield, which should open in the second quarter of 2008. In addition to these full-service branches, the Bank has an agricultural credit unit and an SBA lending unit with staff located at our corporate headquarters, eight offsite ATMs, and a virtual branch through which customers can open deposit accounts and submit certain loan applications online. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2006 have been reclassified to be consistent with the reporting for 2007. The interim financial information should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission.

Note 3 Current Accounting Developments

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) which clarifies the accounting and disclosure for uncertainty in tax positions as defined. FIN 48 seeks to reduce the diversity in certain recognition and measurement practices related to accounting for income taxes. We adopted FIN 48 effective January 1, 2007, and have determined that as of September 30, 2007 any uncertain tax positions that might exist are immaterial.

Table of Contents

In February 2006, the FASB issued Statement of Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (FAS 155). FAS 155 simplifies accounting for certain hybrid instruments currently governed by SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, by allowing fair value re-measurement of hybrid instruments that contain an embedded derivative that otherwise would require bifurcation. FAS 155 also eliminates the guidance in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets, which provides that such beneficial interests are not subject to SFAS No. 133. FAS 155 amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a Replacement of FASB Statement No. 125, by eliminating the restriction on passive derivative instruments that a qualifying special-purpose entity may hold. We adopted this statement effective January 1, 2007. It has not had, nor is it expected to have, a material impact on the Company s financial condition, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (FAS 156). FAS 156 requires an entity to recognize a servicing asset or servicing liability when it undertakes an obligation to service a financial asset in specific situations. The servicing asset or servicing liability shall be initially measured at fair value; however, an entity may elect the amortization method or fair value method for subsequent balance sheet reporting periods. We adopted this statement effective January 1, 2007. It has not had, nor is it expected to have, a material impact on the Company s financial condition, results of operations or cash flows.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on the subject titled Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Arrangements. The EITF has concluded that the recognition of a liability is required for the postretirement benefits provided through an endorsement split-dollar life insurance arrangement. Pursuant to the final consensus, if an employer has promised to pay a death benefit directly from the company to a participant (or designated beneficiary), then a liability for the present value of the death benefit must be accrued over the participant s required service period. However, if the employer has agreed to maintain a split-dollar arrangement and share some portion of the death benefits of the underlying insurance policy, then the postretirement cost of insurance, rather than the death benefit, should be accrued. Since most of the Company s agreements involving postretirement death benefits are split-dollar arrangements associated with an underlying insurance policy, we anticipate that our accrual requirement will, for the most part, be limited to the postretirement cost of insurance. The new guidance will be effective for fiscal years beginning after December 15, 2007. Transition to the new guidance requires a cumulative-effect adjustment to retained earnings at the beginning of the year of implementation, to reflect the change in accounting principle. We have engaged a consultant to review our split-dollar life insurance agreements and provide accounting assistance, and initial estimates are that this EITF guidance could result in a one-time charge to capital of about $1.1 million upon implementation on January 1, 2008, and a quarterly charge to expense of about $30,000 thereafter.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (FAS 157). FAS 157 enhances existing guidance for measuring assets and liabilities using fair value. Prior to the issuance of FAS 157, guidance for applying fair value was incorporated in several accounting pronouncements. FAS 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. FAS 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under FAS 157, fair value measurements are disclosed by level within that hierarchy. While FAS 157 does not add any new fair value measurements, it does change current practice. Changes to practice include: (1) a requirement for an entity to include its own credit standing in the measurement of its liabilities; (2) a modification of the transaction price presumption; (3) a prohibition on the use of block discounts when valuing large blocks of securities for broker-dealers and investment companies; and (4) a requirement to adjust the value of restricted stock for the effect of the restriction even if the restriction lapses within one year. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

Table of Contents

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (FAS 159). FAS 159 permits the measurement of many financial instruments and certain other balance sheet items at fair value, in order to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Upon adoption, balance sheet items designated for fair value accounting are marked to market through equity, and the fair value option may also be selectively applied to items acquired after the adoption date. Unrealized gains and losses on all items so designated are reported in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument (with a few exceptions), and is applied only to entire instruments and not to portions thereof. FAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Other than our investments which are currently classified as available-for-sale and are thus reported at fair value in accordance with FAS 115, we do not anticipate that fair value accounting will be applied to any balance sheet item upon adoption of FAS 159 and FAS 157 on January 1, 2008, in which case there would be no impact on our financial condition, results of operations or cash flows.

Note 4 Supplemental Disclosure of Cash Flow Information

During the nine months ended September 30, 2007 and 2006, cash paid for interest due on interest-bearing liabilities was $24.1 million and $16.2 million, respectively. There was $6.1 million in cash paid for income taxes during the nine months ended September 30, 2007, and $5.5 million paid for income taxes during the nine months ended September 30, 2006. There were two mobile homes acquired in the settlement of $76,000 in loans for the nine months ended September 30, 2007, and no real estate or related assets acquired for the nine months ended September 30, 2006. There were no loans made to finance the sale of other real estate during either of those periods.

Note 5 Share Based Compensation

On March 15, 2007, the Company s Board of Directors approved a new equity compensation plan, the 2007 Stock Incentive Plan (the 2007 Plan), which was approved by the Company s shareholders on May 23, 2007. Our 1998 Stock Option Plan (the 1998 Plan) was concurrently terminated, although 700,061 options granted prior to the termination of the 1998 Plan were still outstanding as of September 30, 2007 and were not affected by the termination. 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. 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 at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company s authorized but unissued stock reserved and available for issuance pursuant to Awards under the 2007 Plan is 1,500,000 shares.

There were no stock options granted by the Company in the third quarter of 2007, although 15,000 shares were granted under the 1998 Plan in the third quarter of 2006. The options granted during the third quarter of 2006 had a calculated fair value of $7.07 per share using the following assumptions: Expected dividend yield of 1.8%; volatility of 25.7%; average risk-free interest rate of 4.82%; and expected weighted average option term of 4.8 years.

Pursuant to FASB Statement 123(R), share-based employee compensation expense is reflected in our income statement for each option granted, over the vesting period of such option. The Company is utilizing the Black-Scholes model to value stock options, and the multiple option approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee s options for each vesting period are separately valued and amortized. This appears to be the FASB-preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A charge of $57,000 was reflected in the Company s income statement during the third quarter of 2007 and $75,000 was reflected during the third quarter of 2006, as pre-tax compensation expense related to outstanding and unvested stock options. For the first nine months, these charges amounted to $246,000 in 2007 and $262,000 in 2006.

Table of Contents

Note 6 Earnings Per Share

Earnings per share for all periods presented in the Consolidated Statements of Income are computed based on the weighted average number of shares outstanding during each period. There were 9,672,247 weighted average shares outstanding during the third quarter of 2007, and 9,773,097 during the third quarter of 2006. There were 9,713,097 weighted average shares outstanding during the first nine months of 2007, and 9,763,707 during the first nine months of 2006.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of outstanding stock options. The dilutive effect of all options outstanding was calculated using the treasury stock method, excluding anti-dilutive transactions and adjusting for unamortized expense and windfall tax benefits. For the third quarter and first nine months of 2007, the dilutive effect of options outstanding calculated under the treasury stock method totaled 336,216 and 363,021, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the third quarter and first nine months of 2006, shares totaling 515,720 and 512,874, respectively, were added to basic weighted average shares outstanding to calculate diluted earnings per share.

Note 7 Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company s only source of other comprehensive income is derived from unrealized gains and losses on investment securities available-for-sale. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company s comprehensive income was as follows (dollars in thousands):

	For the Three-month Period Ended September 30,		For the Nine-month Period Ended September 30,	
	2007	**2006**	**2007**	**2006**
Net income	$ 5,270	$ 4,902	$ 16,078	$ 14,451
Other comprehensive income/(loss):				
Unrealized holding gain/(loss)	2,782	2,363	378	(759)
Less: reclassification adjustment	2	9	14	9
Pre-tax other comprehensive inc/(loss)	2,780	2,354	364	(768)
Less: tax impact of above	1,169	990	153	(351)
Net other comprehensive income/(loss)	1,611	1,364	211	(417)
Comprehensive income	$ 6,881	$ 6,266	$ 16,289	$ 14,034

Note 8 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, which is necessary for us to meet the financing needs of our customers. These financial instruments consist of commitments to extend credit and to issue standby letters of credit. The Company uses the same credit policies in making commitments that it does for making loans included on the balance sheet. 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, total commitment amounts do not necessarily represent future cash requirements.

Table of Contents

The Company s exposure to credit loss for commitments to extend credit and issue letters of credit is represented by the contractual amount of those instruments, and a $160,000 reserve for potential losses on unfunded commitments is reflected as a liability on the Company s balance sheet at September 30, 2007. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	September 30, 2007		December 31, 2006	
Commitments to extend credit	$	223,626	$	261,316
Standby letters of credit	$	9,398	$	17,139
Commercial letters of credit	$	10,789	$	11,393
Credit card commitments	$		$	39,602

Commitments to extend credit consist primarily of unfunded single-family residential construction loans, home equity lines of credit, 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.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company s commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as the risk in extending unsecured loans to customers.

Note 9 Recent Developments

On March 15, 2007, the Board of Directors of Bank of the Sierra approved the sale of the Bank s credit card portfolio, consisting of $8.2 million in consumer card balances and $2.6 million in commercial loan balances. This decision was reached because of the financial benefits of a sale, as well as the expanded credit card options and superior service that the purchaser can provide to our customers. The sale of our Credit Card Portfolio to Elan Financial Services, a wholly owned subsidiary of U.S. Bancorp, took place effective June 1, 2007. It generated a premium on balances sold of about $1.2 million and enabled us to release the approximate $400,000 liability we had accrued for the redemption of credit card scorecard points, for a total pre-tax gain of $1.6 million. The sale also freed up the $500,000 loan loss allowance allocated to credit card balances. In projecting the impact of the sale on operating income going forward, it should be noted that we will continue to participate in a share of the interchange and interest revenue generated by credit cards issued in our name. Furthermore, we have eliminated most of the costs associated with our credit cards, including funding costs, personnel costs, servicing costs, net loan losses, and the scorecard liability accrual. With the exception of the gain on sale and conversion-related costs, the sale-related impact on pre-tax operating income has thus far been immaterial.

The Company recently entered into new contracts for debit and ATM networks, as well as for processing debit and ATM transactions. Based on growth expectations for debit and ATM transactions and relative to the terms of the previous contracts, the new contracts are expected to enhance the Company s pre-tax income by approximately $2.9 million over five years upon conversion in mid-November 2007, although that amount could ultimately be significantly different than projected. For the 12 month period commencing in mid-November 2007, the total pre-tax income enhancement is expected to be close to $450,000, of which approximately $300,000 should be from reduced non-interest expense and the remainder should be in the form of higher non-interest revenue. The new contracts will allow us to enhance customer service by implementing new programs and technologies such as debit rewards, contactless debit cards, and improved fraud detection capabilities.

On October 18, 2007, the Board of Directors of the Company approved a $0.16 per share dividend. The dividend is payable on November 15, 2007 to shareholders of record as of November 1, 2007. The total dividend will be approximately $1.56 million and represents about 30% of third quarter consolidated net income, which is close to the average payout ratio for all publicly-traded financial institutions during 2006. The recommended dividend meets all applicable legal and regulatory requirements for the Company.

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 2

MANAGEMENT S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as expects , anticipates , believes , projects , and estimates or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company s financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include but are not limited to the possibility of deterioration in economic conditions in the Company s service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

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 the Provision for Loan and Lease Losses and Allowance for Loan and Lease Losses sections of this discussion and analysis; deferred loan origination costs, which are estimated based on an annual evaluation of expenses (primarily salaries) associated with successful loan originations and are allocated to individual loans as they are booked, but can actually vary significantly for individual loans depending on the characteristics of such loans; income taxes, 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 based on changes in the market capitalization of the Company and for which management has determined that no impairment exists, as discussed further in Other Assets ; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. 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.

Table of Contents

OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

Third quarter 2007 Compared to Third quarter 2006

Net income for the quarter ended September 30, 2007 was $5.3 million compared to $4.9 million for the quarter ended September 30, 2006, an improvement of 8%. Basic and diluted earnings per share for the third quarter of 2007 were $0.54 and $0.53, respectively, compared to $0.50 and $0.48 for the third quarter of 2006. The Company s annualized return on average equity was 22.16% and annualized return on average assets was 1.73% for the quarter ended September 30, 2007, compared to a return on equity of 22.73% and return on assets of 1.68% for the quarter ended September 30, 2006. The primary drivers behind the variance in net income are as follows:

Net interest income increased by $114,000, or 1%. The percentage increase in net interest income was substantially lower than the 5% increase in average earning assets due to compression in our net interest margin, which was 21 basis points lower in the third quarter of 2007 than in the third quarter of 2006 primarily because of the relatively higher cost and higher proportion of interest-bearing liabilities.

The provision for loan losses was $351,000 lower in the third quarter of 2007 than in the third quarter of 2006, due to the comparative lack of loan growth and a higher level of recoveries on previously charged-off loans in the third quarter of 2007.

Despite a slightly lower level of average transaction account balances, service charges on deposit accounts increased by $607,000, or 41%. This substantial increase in fees was due to a higher number of deposit accounts, which contributed to additional overdraft activity, and an upward adjustment in our fee structure.

Other non-interest revenue declined slightly, because higher income from bank-owned life insurance (BOLI) was more than offset by higher costs on an increased investment in tax credit funds and lower non-interest fees related to credit cards.

The expense recorded for salaries and benefits declined by $38,000, or 1%. Although there were additional salaries and benefits related to our new Delano branch along with regular annual salary adjustments, they were more than offset by an increase in salaries expense deferred for future recognition pursuant to FAS 91. The deferral increased because of a revision in our estimate of the personnel costs involved in each successfully-originated loan, pursuant to an annual review of such costs.

Occupancy expense was virtually unchanged, because normal inflationary increases and occupancy costs associated with the Delano branch were offset by a drop in depreciation expense on certain fixtures and equipment which became fully depreciated during the third quarter of 2007.

Two of the largest contributors to the $591,000, or 24%, increase in the Other category in Other operating expense were an increase of $125,000 in marketing expense associated with our current deposit initiatives, and an increase of $71,000 in credit card costs caused by a one-time conversion-related charge of $250,000. Other significant increases include postage related to customer compliance mailings and direct-mail marketing, consulting costs stemming from our review of electronic funds transfer contracts, and an increase in our accrual for earnings on directors deferred compensation balances.

The Company s tax accrual rate dropped slightly to 33.2% in the third quarter of 2007 from 33.9% in the third quarter of 2006, principally because of an additional $3 million tax-credit investment commitment made in August 2007.

Table of Contents

First Nine months of 2007 Compared to First Nine months of 2006

Net income for the first nine months of 2007 was $16.1 million, which is $1.6 million higher than net income for the first nine months of 2006 and represents an 11% increase. Basic and diluted earnings per share were $1.66 and $1.60 for the first nine months of 2007, compared to $1.48 and $1.41 for the first nine months of the prior year. The Company realized an annualized return on average equity of 23.17% for the first nine months of 2007 and 23.31% for the first nine months of 2006, and achieved a return on assets for the same periods of 1.78% and 1.74%, respectively. The principal reasons for the net income variance for the first nine months include the following:

The Company sold $11 million in credit card balances in June 2007, resulting in a $1.6 million pre-tax gain on sale of loans that equates to an increase of approximately $930,000 in net income. This gain added $0.10 to diluted earnings per share for the first nine months of 2007, and boosted the Company s annualized return on average equity and return on average assets for the same period by about 125 basis points and 10 basis points, respectively.

Net interest income increased by $776,000, or 2%. Again, this was proportionately less than the 9% increase in average earning assets because of a 35 basis point drop in our net interest margin for the year-to-date period.

The provision for loan losses was $848,000 lower in the first nine months of 2007, due to the sale of our credit card loans, slower growth in other loan categories, and a higher level of recoveries in 2007.

Service charges on deposits increased by $941,000, or 21%, with most of the increase occurring in the third quarter for the reasons noted in the quarterly summary.

In addition to service charges on deposits and gains on the sale of loans, other year-to-date non-interest income increased by $340,000, or 9%, due mainly to an increase in income from BOLI.

Salaries and benefits increased by $949,000, or 8%, in part because salaries deferred pursuant to FAS 91 were $411,000 lower for the year-to-date period. Lower loan origination activity during most of 2007 caused the decline in the FAS 91 deferral amount, although the decline was partially offset by the aforementioned adjustment in per-loan expense deferrals in the third quarter. Costs associated with our Delano branch and regular annual salary increases also contributed to the year-to-date increase in salaries and benefits.

Occupancy expense declined by $104,000, or 2%, on a year-to-date basis, because increased rent and premises depreciation were more than offset by lower depreciation expense on furniture and equipment and first quarter 2007 property tax refunds resulting from re-assessments.

Other non-interest expenses increased by $1.1 million, or 14%, due mainly to a $528,000 increase in marketing expense. The other non-interest expense categories referenced in the quarterly comparison were also factors impacting the year-to-date variance, as was a $145,000 reduction in foreclosed asset costs stemming from a first quarter 2006 charge to write-down a foreclosed property.

The tax accrual rate for the first nine months of 2007 was slightly higher, because the additional income generated by the credit card loan sale is taxable at our 42% blended marginal rate.

FINANCIAL CONDITION SUMMARY

September 30, 2007 relative to December 31, 2006

The Company s total assets were $1.208 billion at September 30, 2007, a decline of $7 million relative to total assets of $1.215 billion at December 31, 2006. The most significant characteristics of and changes in the Company s balance sheet during the first nine months of 2007 are outlined below:

Total assets declined because loan growth was more than offset by a $15 million reduction in cash and due from banks, a $6 million decline in fed funds sold, and a $6 million drop in investment securities.

Table of Contents

Net growth in gross loan and lease balances was only $19 million, or 2%. This relatively low growth rate was due to the sale of $11 million in credit card balances in the second quarter, and net runoff of about $3 million in the third quarter resulting from weakening loan demand.

Nonperforming assets ended the period at $1.2 million, or 0.14% of gross loans plus foreclosed assets. This represents an increase from $689,000 or 0.08% at December 31, 2006, but current non-performing assets are predominantly secured by real estate and are still quite low relative to levels seen in years past. The Company has no subprime exposure in its loan portfolio.

The Company had net loan losses of $1.7 million in the first nine months of 2007 compared to net losses of $1.6 million in the first nine months of 2006. Net loan losses in the first nine months of 2007 include $168,000 attributable to a single commercial loan relationship, along with several unsecured consumer credit lines and equity lines. Also factored in for 2007 is $828,000 in year-to-date recoveries of previously charged-off loan balances, which exceed recoveries for the same period in the prior year by $259,000.

Total deposits increased by $18 million, or 2%. Since wholesale-sourced brokered deposits fell by $20 million, customer deposits actually grew by $38 million and would have grown by even more if not for the temporary quarter-end loss of a single $8 million deposit. Overall, deposits experienced a significant shift out of non-interest demand and savings accounts and into NOW accounts, money market accounts, and time deposits. This shift contributed to our increased funding costs.

Because deposits grew yet total assets declined, we were able to reduce our reliance on other borrowings by $36 million.

EARNINGS PERFORMANCE

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 interest-bearing liabilities. 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

For the third quarter, net interest income increased by $114,000, or 1%, to $14.1 million in 2007 from $13.9 million in 2006. For the first nine months, net interest income increased by $776,000, or 2%, to $42.3 million in 2007 from $41.5 million in 2006. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company s earning assets, deposits, and other interest-bearing liabilities. Occasionally, net interest income is also impacted by the recovery of interest on loans that have been on non-accrual status and are either sold or returned to accrual status, or by the reversal of accrued but unpaid interest for loans placed on non-accrual status.

The following Average Balances and Rates table shows, for the quarters noted, the average balance of each principal balance sheet category and the amount of interest income or interest expense associated with that category. This table also shows the calculated yields on each major component of the Company s investment and loan portfolio, the average rates paid on each key segment of the Company s interest bearing liabilities, and the net interest margin.

Table of Contents

Average Balances and Rates

(dollars in thousands, except per share data)

	For the Quarter Ended September 30, 2007 (a) (b) (f)			For the Quarter Ended September 30, 2006 (a) (b) (f)		
	Average Balance	**Income/ Expense**	**Average Rate/ Yield**	**Average Balance**	**Income/ Expense**	**Average Rate/ Yield**
Assets						
Investments:						
Federal funds sold/Due from time	$ 1,443	$ 21	5.77%	$ 712	$ 8	4.46%
Taxable	129,871	1,512	4.62%	138,458	1,558	4.46%
Non-taxable	54,979	559	6.21%	51,375	519	6.17%
Equity	12		0.00%	9		0.00%
Total Investments	186,305	2,092	5.10%	190,554	2,085	4.92%
Loans and Leases:(c) (e)						
Agricultural	10,754	222	8.19%	11,578	240	8.22%
Commercial	137,958	3,287	9.45%	140,916	3,376	9.50%
Real Estate	679,199	14,853	8.68%	616,778	13,671	8.79%
Consumer	55,938	1,480	10.50%	54,523	1,329	9.67%
Consumer Credit Cards		(28)	0.00%	8,383	207	9.80%
Direct Financing Leases	18,122	284	6.22%	14,371	223	6.16%
Other	957		0.00%	438		0.00%
Total Loans and Leases	902,928	20,098	8.83%	846,987	19,046	8.92%
Total Interest Earning Assets (e)	1,089,233	22,190	8.19%	1,037,541	21,131	8.19%
Other Earning Assets	6,581			8,899		
Non-Earning Assets	110,511			108,606		
Total Assets	$ 1,206,325			$ 1,155,046		
Liabilities and Shareholders Equity						
Interest Bearing Deposits:						
NOW	$ 79,838	$ 91	0.45%	$ 61,336	$ 17	0.11%
Savings Accounts	55,441	75	0.54%	67,620	90	0.53%
Money Market	146,507	1,164	3.15%	133,867	972	2.88%
TDOA s & IRA s	24,479	234	3.79%	24,046	214	3.53%
Certificates of Deposit<$100,000	122,663	1,394	4.51%	95,548	926	3.84%
Certificates of Deposit≥$100,000	242,718	3,010	4.92%	181,563	2,095	4.58%
Total Interest Bearing Deposits	671,646	5,968	3.53%	563,980	4,314	3.03%
Borrowed Funds:						
Federal Funds Purchased	24,685	346	5.56%	12,219	165	5.36%
Repurchase Agreements	20,979	38	0.72%	22,302	40	0.71%
Short Term Borrowings	99,067	1,158	4.64%	118,139	1,481	4.97%
Long Term Borrowings	5,000	42	3.33%	27,000	212	3.12%
TRUPS	30,928	576	7.39%	46,392	971	8.30%

Total Borrowed Funds	180,659	2,160	4.74%	226,052	2,869	5.04%
Total Interest Bearing Liabilities	852,305	8,128	3.78%	790,032	7,183	3.61%
Demand Deposits	242,534			263,137		
Other Liabilities	17,124			16,313		
Shareholders Equity	94,362			85,564		
Total Liabilities and Shareholders Equity	$ 1,206,325			$ 1,155,046		
Interest Income/Interest Earning Assets			8.19%			8.19%
Interest Expense/Interest Earning Assets			2.96%			2.75%
Net Interest Income and Margin[(d)]		$ 14,062	5.23%		$ 13,948	5.44%

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

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

(c) Loan fees have been included in the calculation of interest income. Loan fees were approximately $409 thousand and $709 thousand for the quarters ended September 30, 2007 and 2006. Loans are gross of the allowance for possible loan losses.

(d) Represents net interest income as a percentage of average interest-earning assets.

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

(f) Annualized.

Table of Contents

Similar information, only for year-to-date periods, is presented in the following Average Balances and Rates table:

Average Balances and Rates

(dollars in thousands, except per share data)

	Nine Months Ended September 30, 2007 (a) (b) (f)			Nine Months Ended September 30, 2006 (a) (b) (f)		
	Average Balance	Income/ Expense	Average Rate/ Yield	Average Balance	Income/ Expense	Average Rate/ Yield
Assets						
Investments:						
Federal funds sold/Due from time	$ 988	$ 39	5.28%	$ 843	$ 25	3.96%
Taxable	133,081	4,588	4.61%	143,482	4,763	4.44%
Non-taxable	54,899	1,664	6.23%	50,337	1,509	6.17%
Equity	10		0.00%	10		0.00%
Total Investments	188,978	6,291	5.08%	194,672	6,297	4.88%
Loans and Leases: (c) (e)						
Agricultural	10,881	665	8.17%	10,278	659	8.57%
Commercial	138,939	9,870	9.50%	135,968	9,471	9.31%
Real Estate	670,816	43,911	8.75%	585,169	37,671	8.61%
Consumer	56,160	4,250	10.12%	53,137	3,742	9.42%
Consumer Credit Cards	4,694	384	10.94%	8,443	621	9.83%
Direct Financing Leases	17,503	826	6.31%	12,032	554	6.16%
Other	631		0.00%	403		0.00%
Total Loans and Leases	899,624	59,906	8.90%	805,430	52,718	8.75%
Total Interest Earning Assets (e)	1,088,602	66,197	8.24%	1,000,102	59,015	8.00%
Other Earning Assets	8,014			7,506		
Non-Earning Assets	111,342			105,209		
Total Assets	$ 1,207,958			$ 1,112,817		
Liabilities and Shareholders Equity						
Interest Bearing Deposits:						
NOW	$ 74,902	$ 201	0.36%	$ 66,075	$ 51	0.10%
Savings Accounts	58,328	229	0.52%	69,730	274	0.53%
Money Market	137,312	3,170	3.09%	124,128	2,028	2.18%
TDOA s & IRA s	24,153	687	3.80%	23,345	559	3.20%
Certificates of Deposit<$100,000	120,866	4,068	4.50%	91,654	2,420	3.53%
Certificates of Deposit≥$100,000	232,603	8,580	4.93%	174,935	5,547	4.24%
Total Interest Bearing Deposits	648,164	16,935	3.49%	549,867	10,879	2.65%
Borrowed Funds:						
Federal Funds Purchased	21,946	892	5.43%	13,823	518	5.01%
Repurchase Agreements	24,107	134	0.74%	23,994	115	0.64%
Short Term Borrowings	109,228	3,899	4.77%	83,938	2,867	4.57%
Long Term Borrowings	12,898	308	3.19%	34,586	768	2.97%

TRUPS	30,928	1,705	7.37%	37,046	2,320	8.37%
Total Borrowed Funds	199,107	6,938	4.66%	193,387	6,588	4.55%
Total Interest Bearing Liabilities	847,271	23,873	3.77%	743,254	17,467	3.14%
Demand Deposits	251,381			271,761		
Other Liabilities	16,510			14,923		
Shareholders Equity	92,796			82,879		
Total Liabilities and Shareholders Equity	$ 1,207,958			$ 1,112,817		
Interest Income/Interest Earning Assets			8.24%			8.00%
Interest Expense/Interest Earning Assets			2.93%			2.34%
Net Interest Income and Margin [(d)]		$ 42,324	5.31%		$ 41,548	5.66%

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

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

(c) Loan fees have been included in the calculation of interest income. Loan fees were approximately $1.409 million and $1.848 million for the nine months ended September 30, 2007 and 2006. Loans are gross of the allowance for possible loan losses.

(d) Represents net interest income as a percentage of average interest-earning assets.

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

(f) Annualized.

Table of Contents

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates (rate). 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 average 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.

Volume & Rate Variances

(dollars in thousands)

	Quarter Ended September 30, 2007 over 2006 Increase(decrease) due to				Nine Months Ended September 30, 2007 over 2006 Increase(decrease) due to			
	Volume	Rate	Rate/ Volume	Net	Volume	Rate	Rate/ Volume	Net
Assets:								
Investments:								
Federal funds sold / Due from time	$ 8	2	3	$ 13	$ 4	8	2	14
Taxable	(97)	54	(3)	(46)	(345)	183	(13)	(175)
Non-taxable[1]	37	3		40	137	17	1	155
Equity								
Total Investments	(52)	59		7	(204)	208	(10)	(6)
Loans and Leases:								
Agricultural	(17)	(1)		(18)	39	(31)	(2)	6
Commercial	(71)	(18)		(89)	207	188	4	399
Real Estate	1,384	(183)	(19)	1,182	5,513	634	93	6,240
Consumer	34	114	3	151	213	279	16	508
Consumer Credit Cards	(235)			(235)	(276)	70	(31)	(237)
Direct Financing Leases	58	2	1	61	252	14	6	272
Other								
Total Loans and Leases	1,153	(86)	(15)	1,052	5,948	1,154	86	7,188
Total Interest Earning Assets	1,101	(27)	(15)	1,059	5,744	1,362	76	7,182
Liabilities								
Interest Bearing Deposits:								
NOW	5	53	16	74	7	126	17	150
Savings Accounts	(16)	1		(15)	(45)			(45)
Money Market	91	92	9	192	215	838	89	1,142
TDOA s & IRA s	4	16		20	19	105	4	128
Certificates of Deposit < $100,000	263	160	45	468	771	665	212	1,648
Certificates of Deposit ≥ $100,000	705	157	53	915	1,829	906	298	3,033
Total Interest Bearing Deposits	1,052	479	123	1,654	2,796	2,640	620	6,056
Borrowed Funds:								
Federal Funds Purchased	168	6	7	181	304	44	26	374
Repurchase Agreements	(2)			(2)	1	18		19
Short Term Borrowings	(239)	(100)	16	(323)	864	129	39	1,032
Long Term Borrowings	(173)	15	(12)	(170)	(482)	58	(36)	(460)
TRUPS	(324)	(107)	36	(395)	(383)	(278)	46	(615)

Total Borrowed Funds	(570)	(186)	47	(709)	304	(29)	75	350
Total Interest Bearing Liabilities	482	293	170	945	3,100	2,611	695	6,406
Net Interest Margin/Income	$ 619	$ (320)	$ (185)	$ 114	$ 2,644	$ (1,249)	$ (619)	$ 776

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

As shown above, pure volume variances contributed $619,000 to net interest income in the third quarter of 2007 relative to the third quarter of 2006. The positive volume variance is the result of growth in average interest-earning assets, as evident in the Average Balances and Rates table for the quarter. Average interest-earning assets were $52 million higher in the third quarter of 2007 than in the third quarter of 2006, an increase of 5%. The increase was due to growth of $56 million, or 7%, in average loan balances, partially offset by a decline of $4 million, or 2%, in average investment balances. Average other earning (non-interest) assets plus non-earning assets were 10% of average total assets in the third quarters of both 2007 and 2006, although the ratio of average demand deposits, other liabilities, and shareholders equity to average assets declined to 29% in the third quarter of 2007 from 32% in the third quarter of 2006, due mainly to the fact that demand deposit balances were $21 million lower. This had the unfavorable effect of increasing the percentage of the Company s assets that are funded by interest-bearing liabilities.

The volume variance was also negatively impacted by a shift in our deposit mix to higher-cost deposits. The average balance of total interest-bearing deposits increased by $108 million, or 19%, for the third quarter of 2007, with most of the increase coming in higher-cost deposit categories. For the third quarter of 2007 relative to the third quarter of 2006, average time deposits were up by $89 million, or 29%, and money market accounts increased by $13 million, or 9%, while lower-cost NOW account balances increased by $19 million, or 30%, and savings accounts fell by $12 million, or 18%. The overall growth in average deposits allowed us to retire some of our costly borrowings, though, helping to soften the negative impact of the deposit shift. The average balance of borrowed funds was $45 million lower in the third quarter of 2007 than in the third quarter of 2006, a drop of 20%.

The shift in our deposit mix caused our weighted average cost of interest-bearing deposits to increase by 50 basis points for the quarterly comparison, which was the reason for the 17 basis point increase in the cost of interest-bearing liabilities. Since the weighted average yield on earning assets was the same in both the third quarter of 2007 and the third quarter of 2006, the higher cost of interest-bearing liabilities was the cause of our negative $320,000 rate variance for the quarter.

The Company s net interest margin, which is tax-equivalent net interest income expressed as a percentage of average interest-earning assets, is affected by many of the same factors discussed relative to rate and volume variances. Our net interest margin was 5.23% in the third quarter of 2007 as compared to 5.44% in the third quarter of 2006, a drop of 21 basis points. During much of the intervening period the Company s interest rate risk position was slightly asset-sensitive, meaning that all else being equal the Company s net interest margin would typically be favorably impacted when rates are rising and negatively impacted when rates decline. In reality, short-term rates were rising for a period of about two years prior to third quarter 2006, and remained relatively stable thereafter until the Federal Reserve Board approved a decrease in the fed funds rate in mid-September 2007. After rates stopped increasing in 2006, deposit rates, which typically lag when market interest rates are increasing, began to catch up to the increases experienced in earning asset yields when rates were rising. This contributed to the decline in our net interest margin. The drop in average non-interest bearing and lower-cost core deposits and our relatively low-margin growth during the last half of 2006 also had a negative impact.

Our net interest margin for the third quarter of 2007 would have been even lower, but strong growth in aggregate deposits and declining assets during 2007 allowed us to reduce our reliance on wholesale borrowings and partially offset some of the negative factors noted in the previous paragraph. Because of our current interest rate risk profile, the Company s net interest margin could experience a short-term boost from declining rates, but would likely suffer from further compression in the longer-term under declining rate scenarios or if interest rates were to rise. That negative impact will be partially offset and net interest income should continue to increase if we are able to reverse current trends and successfully grow our loans and core deposits.

For the first nine months of 2007 relative to the first nine months of 2006, the favorable volume variance in net interest income was $2.6 million, while the rate variance was negative $1.2 million and the variance attributable to both rate and volume was negative $619,000. As with the quarterly results, growth in earning assets had the biggest impact on the volume variance for the year-to-date period. Average interest-earning assets were $89 million higher in the first nine months of 2007 than in the first nine months of 2006, an increase of 9%. This increase was the result of growth in average loan balances totaling $94 million, or 12%, which was partially offset by a decline of $6 million, or 3%, in average investment balances. As with the quarterly comparison, a $20 million drop in average demand deposits was the primary contributor to a lower ratio of average demand deposits, other liabilities, and shareholders equity to average assets, which had a negative impact on the year-to-date volume variance. A shift among average interest-bearing deposits to higher-cost categories is also evident in the year-to-date numbers. The deposit changes include an increase of $88 million, or 30%, in the average balance of relatively costly time deposits, and an increase of $13 million, or 11% in average money market deposits. Average NOW accounts increased by $9 million, or 13%, and savings deposits fell by $11 million, or 16%.

The unfavorable rate variance for the first nine months was due to the fact that our cost of interest-bearing liabilities increased by 63 basis points, while our yield on interest-earning assets increased by only 24 basis points. The impact of the disproportionate increase in the cost of interest-bearing liabilities was mitigated somewhat by the Company s large net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. The Company s net interest position was $257 million in the first nine months of 2006, the base period for the rate variance calculations, thus the rate increase for earning assets was applied to a substantially larger volume than the rate increase for interest-bearing liabilities and had a relatively larger impact. The Company s net interest margin for the first nine months of 2007 was 5.31%, a decline of 35 basis points relative to the net interest margin of 5.66% in the first nine months of 2006, due to the factors delineated in the quarterly comparison.

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 through periodic charges to earnings, which are reflected in the income statement as the provision for loan losses. These charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management s judgment, is adequate to absorb losses inherent in the Company s loan portfolio.

Our loan loss provision was $351,000 lower for the third quarter and $848,000 lower for the year-to-date period in 2007 relative to 2006. The specific reserves for potential losses on a certain agricultural production loan were increased in 2007, and reserves have been strengthened for balances outstanding on equity lines and unsecured credit lines, but the impact of those increases on our loan loss provision was offset by the effect of a lower rate of growth in loan balances and a higher level of recoveries on previously charged-off balances in 2007. Recoveries, which are added back to the allowance for loan and lease losses and thus help reduce our need for a provision, were $349,000 for the third quarter of 2007 and $112,000 for the third quarter of 2006. Recoveries were $828,000 for the first nine months of 2007, and $569,000 for the like period in 2006. The year-to-date comparison was also affected by the release of the $500,000 loan loss allowance associated with credit card balances that were sold in the second quarter of 2007. The procedures for monitoring the adequacy of the allowance, and detailed information on the allowance, are included below in Allowance for Loan and Lease Losses.

Table of Contents

NON-INTEREST REVENUE AND OPERATING EXPENSE

The following table provides details on the Company s non-interest income and operating expense for the third quarter and first nine months of 2007 relative to the third quarter and first nine months of 2006:

Non Interest Income/Expense

(dollars in thousands, unaudited)

	For the Quarter Ended September 30,				For the Nine-Month Period Ended September 30,			
	2007	% of Total	2006	% of Total	2007	% of Total	2006	% of Total
OTHER OPERATING INCOME:								
Service charges on deposit accounts	$ 2,105	62.54%	$ 1,498	53.35%	$ 5,434	48.95%	$ 4,493	54.64%
Other service charges, commissions & fees	798	23.71%	1,043	37.14%	2,779	25.03%	2,835	34.47%
Gains on sales of loans	(20)	-0.59%		0.00%	1,598	14.39%		0.00%
Gains on called securities	2	0.06%	9	0.32%	14	0.13%	9	0.11%
Loan servicing income	34	1.01%	25	0.89%	58	0.52%	45	0.55%
Bank owned life insurance	327	9.71%	142	5.06%	940	8.47%	578	7.03%
Other	120	3.56%	91	3.24%	279	2.51%	263	3.20%
Total non-interest income	3,366	100.00%	2,808	100.00%	11,102	100.00%	8,223	100.00%
As a % of average interest-earning assets [2]		1.23%		1.07%		1.36%		1.10%
OTHER OPERATING EXPENSES:								
Salaries and employee benefits	4,045	45.75%	4,083	49.25%	13,143	49.06%	12,194	49.07%
Occupancy costs								
Furniture & equipment	742	8.39%	803	9.68%	2,273	8.48%	2,435	9.80%
Premises	959	10.85%	900	10.85%	2,535	9.46%	2,477	9.96%
Advertising and marketing costs	415	4.69%	290	3.50%	1,335	4.98%	807	3.25%
Data processing costs	312	3.53%	305	3.68%	836	3.12%	816	3.28%
Deposit services costs	515	5.82%	436	5.26%	1,416	5.29%	1,374	5.53%
Loan services costs								
Loan processing	75	0.85%	37	0.45%	135	0.50%	216	0.87%
Foreclosed assets	1	0.01%	1	0.01%	6	0.02%	151	0.61%
Credit card	249	2.82%	178	2.15%	591	2.21%	534	2.15%
Other operating costs								
Telephone & data communications	214	2.42%	207	2.50%	664	2.48%	612	2.46%
Postage & mail	143	1.62%	86	1.04%	380	1.42%	250	1.01%
Other	253	2.86%	264	3.18%	898	3.35%	802	3.23%
Professional services costs								
Legal & accounting	322	3.64%	324	3.91%	927	3.46%	865	3.48%
Other professional service	364	4.12%	217	2.62%	973	3.63%	758	3.05%
Stationery & supply costs	155	1.75%	138	1.66%	489	1.83%	472	1.90%
Sundry & tellers	78	0.88%	22	0.26%	191	0.71%	88	0.35%
Total non-interest Expense	$ 8,842	100.00%	$ 8,291	100.00%	$ 26,792	100.00%	$ 24,851	100.00%
As a % of average interest-earning assets [2]		3.22%		3.17%		3.29%		3.32%
Efficiency Ratio [1]	49.38%		48.53%		48.87%		48.84%	

[1] Tax Equivalent

(2) Annualized

The Company s results reflect an increase of $558,000, or 20%, in total other operating income for the quarter ended September 30, 2007 relative to the quarter ended September 30, 2006, due mainly to an increase in overdraft and returned item charges as reflected in service charges on deposits. Total other operating income increased to an annualized 1.23% of average earning assets in the third quarter of 2007, from 1.07% of average earning assets in the third quarter of 2006. For the first nine months, total other operating income was $11.1 million in 2007 and $8.2 million in 2006, representing an increase of $2.9 million, or 35%. Much of the year-to-date increase came from the $1.6 million gain on sale of credit card loans that was recognized in the second quarter of 2007, although an increase in service charges on deposits was also a major contributor. Total operating income was an annualized 1.36% of average earning assets in the first nine months of 2007, relative to 1.10% in the first nine months of 2006.

For the third quarter, service charges on deposit accounts increased by $607,000, or 41%, despite a 1% drop in average transaction account balances. For the first nine months, average transaction account balances were 3% lower, but service charges on deposits were up by $941,000, or 21%. The increase in service charges for both the quarter and year-to-date are due in part to an increase in the number of transaction accounts resulting from current marketing initiatives, and higher levels of overdraft activity. At September 30, 2007, the Company had 43,000 deposit accounts that are considered to be transaction accounts (demand deposit and NOW accounts), a 19% increase relative to the number of transaction accounts at September 30, 2006. Recently implemented fee increases and a system upgrade that allows overdrafts on point-of-sale transactions also contributed to the increase in service charges on deposits. We expect that our planned fourth quarter implementation of a deposit scoring system, which allows selective increases in informal overdraft lines and helps minimize our exposure to higher-risk accounts, will lead to even higher levels of deposit-related service charges in the future, although no assurance can be provided in that regard.

Other service charges, commissions, and fees declined by $245,000, or 23%, for the third quarter of 2007 relative to the third quarter of 2006, and by $56,000, or 2%, for the first nine months of 2007 compared to the prior year. The quarterly decline includes the following significant changes: an increase of $118,000 in costs associated with our tax credit investments (reflected as a reduction of income), due in part to an additional $3 million investment commitment made in August 2007; a $207,000 drop in credit card revenue, which is now limited to interchange and interest sharing arrangements subsequent to the sale of our credit card portfolio; and increases of $72,000 and $54,000, respectively, in interchange fees from point-of-sale transactions and operating lease rental income. With new contracts and processing arrangements in the electronic funds transfer (EFT) arena commencing in early November 2007, both the revenue and expense associated with ATM and point-of-sale transactions should be favorably impacted going forward, as discussed in Note 9 to the financial statements.

The year-to-date decline in other service charges, commissions, and fees includes a $184,000 decline in credit card revenue and a $150,000 increase in tax credit investment costs, which were offset by a $178,000 increase in point-of-sale interchange fees, a $141,000 increase in dividends on Federal Home Loan Bank (FHLB) stock, and a $73,000 increase in operating lease income. Numerous other miscellaneous fluctuations make up the difference.

Bank-owned life insurance (BOLI) income increased by $185,000, or 130%, in the third quarter of 2007 relative to the third quarter of 2006, and by $362,000, or 63%, for the first nine months of 2007 compared to the first nine months of 2006. At September 30, 2007 the Company had $25.8 million invested in single-premium general account BOLI, with an interest credit rate that does not change frequently and is floored at no less than 3%. Income from this BOLI is used to fund expenses associated with executive salary continuation plans and director retirement plans. In addition, as of September 30, 2007 the Company had $1.9 million invested in separate account BOLI, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses. Part of the increase in BOLI income for the third quarter of 2007 is due to income from an additional $6 million investment in general account BOLI made in December 2006, but the majority is from a $123,000 increase in income on separate account BOLI. The year-to-date increase is from a $131,000 boost in returns on separate account BOLI, plus income from the additional investment in general account BOLI.

Other non-interest income includes gains and losses on the disposition of real properties and other assets, and rental income generated by the Company s alliance with Investment Centers of America (ICA). Other non-interest income increased by $29,000, or 32%, for the third quarter, and by $16,000, or 6%, for the year-to-date comparison, due mainly to higher ICA income.

Total operating expense (non-interest expense) was $8.8 million for the quarter ended September 30, 2007, an increase of $551,000, or 7%, relative to total operating expense for the same period in 2006. Non-interest expenses rose slightly to an annualized 3.22% of average earning assets for the third quarter of 2007 from 3.17% in the third quarter of 2006. For the first nine months of 2007, total non-interest expense was $1.9 million higher than in the first nine months of 2006, an increase of 8%. Total non-interest expense fell slightly to an annualized 3.29% of average earning assets in the first nine months of 2007, from 3.32% in the first nine months of 2006.

The largest component of non-interest expense, salaries and employee benefits, fell by $38,000, or 1%, for the third quarter of 2007 relative to the third quarter of 2006, and was up by $949,000, or 8%, for the first nine months of 2007 compared to the first nine months of 2006. Both the quarterly decline and the year-to-date increase were significantly affected by fluctuations in salaries attributed to successful loan originations, which are deferred from current expense and amortized as an adjustment to loan yields pursuant to FAS 91. FAS 91 deferrals increased by $149,000 for the quarter because of a revision in our estimate of the personnel costs involved in each successfully-originated loan, pursuant to an annual review of such costs in August 2007. The third quarter increase in deferred salaries was not large enough to offset the year-to-date impact of declining loan origination activity, however, and FAS 91 deferrals thus show a reduction of $411,000 for the nine months ended September 30, 2007 relative to the same period last year. Regular annual salary increases and employee costs for the new Delano branch also impacted both third quarter and year-to-date personnel costs. The cost of benefits increased by $45,000, or 5%, in the third quarter of 2007 relative to the third quarter of 2006, and increased by $46,000, or 1%, on a year-to-date basis. Benefits would have actually declined for both the third quarter and year-to-date comparisons, if not for increases of $70,000 and $71,000, respectively, in third quarter and year-to-date deferred compensation expense. These deferred compensation increases are roughly offset by increases in separate account BOLI income plus related changes in deferred taxes. Factoring out deferred compensation charges, the favorable trend in benefits is due mainly to declining workers compensation insurance premiums, which were down by $17,000 for the third quarter and by $113,000 for the first nine months of 2007 relative to the same periods in 2006. Salaries and benefits fell to 45.8% of total non-interest expense for the third quarter of 2007 from 49.3% in the third quarter of 2006, and was 49.1% of total non-interest expense for the first nine months of 2007 and 2006.

Aggregate occupancy expense was about the same for the third quarter of 2007 compared to 2006, and fell by $104,000, or 2%, for the first nine months of 2007 relative to the prior year. We experienced typical inflationary increases in rent and other occupancy costs in both the third quarter and first nine months of 2007, along with costs associated with our Delano branch which opened in March 2007. However, these increases were offset by lower furniture and equipment depreciation, which was down by $110,000 for the quarterly comparison and by $255,000 for the year-to-date comparison because of some equipment and large fixtures which became fully depreciated. The year-to-date decline also includes a $102,000 drop in property taxes which resulted from one-time property tax refunds received in the first quarter of 2007 pursuant to re-assessments. Occupancy expense was 19.2% of total non-interest expense for the third quarter of 2007, down from 20.5% for the third quarter of 2006, and was 18.0% of total non-interest expense for the first nine months of 2007 as compared to 19.8% in the first nine months of 2006.

Advertising and marketing expenses increased by $125,000, or 43%, for the quarter, and by $528,000, or 65% for the year-to-date period, because of costs associated with our high-performance checking initiative targeting consumer deposits (explained further below, in the Deposits section), which was implemented at the beginning of 2007. Marketing expenses are expected to increase by around $60,000 per quarter commencing in November 2007, when a similar high-performance checking initiative is instituted for business accounts.

Other notable changes in non-interest expenses for the quarter include deposit services costs, credit card costs, postage, directors deferred compensation and EFT contract review expenses included in other professional services , and operational charge-offs included in sundry and tellers . Deposit services costs were up by $79,000, or 18%, mainly because of a $40,000 increase in ATM network costs, although those costs should start to decline in November 2007 as the terms of our new EFT contracts commence. Credit card costs would have been completely eliminated in the third quarter of 2007 if not for a $249,000 conversion fee related to the sale of our credit card portfolio. Our accrual for earnings on deferred compensation balances for select directors increased by $94,000 in the third quarter, although, as noted in the discussion on salaries and benefits, deferred compensation increases are offset by increases in separate account BOLI income plus related changes in deferred taxes. EFT contract review expenses are one-time consulting costs which added about $95,000 to other professional services expense for the quarter. The increase in postage expense of $57,000, or 66%, is related to our current direct-mail marketing initiatives and the cost of mailing certain mandatory compliance notices to our customers. Operational charge-offs, including debit card losses and losses related to other fraudulent deposit activities, more than tripled in the third quarter of 2007 relative to 2006, increasing to $78,000. We are hopeful that a deposit scoring system and an enhanced fraud detection system currently in process of installation will help keep future losses to a minimum.

Significant changes in other year-to-date expenses consist of many of the fluctuations discussed in the previous paragraph, and also include changes in costs associated with foreclosed assets, other operating costs, and legal costs. Credit card costs were up by $57,000, or 11%, postage increased by $130,000, or 52%, and other professional services expense escalated by $215,000, or 28%, all for the same reasons outlined in the comparative third quarter discussion. Foreclosed asset costs declined because of the write-down of other real estate owned (OREO) in the first quarter of 2006. The other category under other operating costs is up by $96,000, or 12%, for the first nine months of 2007 compared to the first nine months of 2006, due mainly to higher depreciation expense on

Table of Contents

operating leases and higher education and training costs in the first quarter of 2007. Comprising most of the $62,000 increase in legal & accounting, legal costs increased by $51,000, or 22%, primarily because of additional costs associated with our proxy statement and annual meeting in 2007.

Since net interest plus non-interest income increased by 4% but non-interest expense increased by 7%, the Company s tax-equivalent overhead efficiency ratio increased to 49.38% for the third quarter of 2007 from 48.53% for the third quarter of 2006. Because of the impact of revenue from the sale of our credit card portfolio in the second quarter of 2007, our year-to-date overhead efficiency ratio of 48.87% for 2007 was almost identical to the ratio of 48.84% achieved for the first nine months of 2006. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains and losses, and other extraordinary income and expenses excluded from the equation.

PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company s statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. The Company s tax provision totaled $2.6 million, or 33.2% of pre-tax income for the third quarter of 2007, and $2.5 million, or 33.9% of pre-tax income for the third quarter of 2006. The primary reason for the declining tax accrual rate is a $3 million tax credit investment committed to in August 2007. Year-to-date, the provision for income taxes increased to $8.3 million, or 33.9% of pre-tax income in 2007, from $7.3 million, or 33.6% of pre-tax income in the first nine months of 2006. The increase in the tax accrual rate for the year-to-date comparison is principally because the $1.6 million gain on sale of loans is taxable at our marginal blended tax rate of 42%.

BALANCE SHEET ANALYSIS

EARNING ASSETS

INVESTMENTS

The major components of the Company s earning asset base are its investments and loans, and the detailed composition and growth characteristics of both are significant determinants of the financial condition of the Company. The Company s investments are analyzed in this section, while the loan and lease portfolio is discussed in a later section of this Form 10-Q.

The Company s investments consist of debt and marketable equity securities (together, the investment portfolio), investments in the time deposits of other banks, and overnight fed funds sold. These 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.

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. Pursuant to SFAS 115, the balance of available for sale securities is carried on the Company s financial statements at its estimated fair market value, with monthly tax-effected mark-to-market adjustments made vis-à-vis the accumulated other comprehensive income account in shareholders equity. The following table sets forth the Company s investment portfolio by investment type as of the dates noted.

Table of Contents

Investment Portfolio

(dollars in thousands, unaudited)

	September 30, 2007		December 31, 2006	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Available for Sale				
US Treasury securities	$ 499	$ 502	$ 501	$ 496
US Gov t agencies	19,602	19,607	18,035	17,879
Mortgage-backed securities	111,088	108,623	121,204	118,175
State & political subdivisions	55,859	55,814	53,387	53,713
Other equity securities	6	11	6	9
Total Investment Securities	$ 187,054	$ 184,557	$ 193,133	$ 190,272

The fair market value (which, for the Company, is the carrying value) of the investment portfolio declined by $6 million, or 3%, during the first nine months of 2007. Approximately $51 million of the portfolio total at September 30, 2007 represents remaining balances from the $100 million leverage strategy implemented in April 2004. The leverage balances are funded in part by $27 million in fixed-rate FHLB borrowings obtained at the commencement of the leverage strategy, of which $5 million is currently classified as long term and $22 million represents balances that mature in April 2008. Short-term FHLB borrowings that are rolled over every 30 to 60 days make up the difference.

During the first nine months of 2007, mortgage-backed securities declined by $10 million due primarily to prepayments associated with the leverage strategy portfolio. Municipal bonds increased by $2 million as the Company has taken advantage of relative value in that sector, and US Government agency bonds were increased by close to $2 million for pledging purposes. Securities that were pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled $165 million at September 30, 2007, and $166 million at December 31, 2006. There were no overnight fed funds sold at September 30, 2007 and $6.3 million at December 31, 2006, and the Company s investment in the time deposits of other banks totaled $80,000 at both September 30, 2007 and December 31, 2006. The balance of fed funds sold typically averages less than $1 million, and the drop in the end-of-period balance is simply due to the timing of cash flows. Aggregate investments were 15% of total assets at September 30, 2007 and 16% at December 31, 2006.

LOAN PORTFOLIO

The Company s loans and leases, gross of the associated allowance for losses and deferred fees and origination costs, totaled $907 million at the end of September 2007. This represents an increase of $19 million, or 2%, since December 31, 2006. Based on a general slowdown in construction and real estate development in our footprint, we expect that the Company could continue to experience relatively slow loan growth for the remainder of the year.

The Company has no subprime exposure in its loan portfolio. However, approximately $10 million in residential mortgage loans and $7 million in residential construction loan balances and commitments are stated income loans, which can be viewed as riskier than loans for which full documentation is provided. To help mitigate this perceived risk, our mortgage loans and construction loans are typically underwritten at loan to value ratios of 80% or less. Furthermore, our conservative underwriting standards help provide assurance that the borrowers on these loans are legitimate, creditworthy borrowers.

A comparative schedule of the distribution of the Company s loans at September 30, 2007 and December 31, 2006, by outstanding balance as well as by percentage of total loans, is presented in the following Loan and Lease Distribution table. The balances shown for each loan type are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs for loans in that category.

Table of Contents

Loan and Lease Distribution

(dollars in thousands, unaudited)

	September 30 2007	December 31 2006
Agricultural	$ 12,296	$ 13,193
Commercial and industrial	114,226	113,644
Real Estate:		
Secured by commercial/professional office	444,277	420,973
Properties including construction and development		
Secured by residential properties	184,934	177,448
Secured by farmland	54,141	53,668
Total Real Estate	683,352	652,089
Small Business Administration loans	20,820	25,946
Consumer loans	54,163	54,568
Consumer Credit Cards		8,418
Direct Financing Leases	21,708	20,150
Total Loans and Leases	$ 906,565	$ 888,008
Percentage of Total Loans and Leases		
Agricultural	1.36%	1.49%
Commercial and industrial	12.60%	12.80%
Real Estate:		
Secured by commercial/professional office		
Properties including construction and development	49.01%	47.41%
Secured by residential properties	20.40%	19.98%
Secured by farmland	5.97%	6.04%
Total Real Estate	75.38%	73.43%
Small Business Administration loans	2.30%	2.92%
Consumer loans	5.97%	6.14%
Consumer Credit cards	0.00%	0.95%
Direct Financing Leases	2.39%	2.27%
Total	100.00%	100.00%

The majority of the year-to-date growth in our loan portfolio was in commercial real estate loans, which increased by $23 million, or 6%. Commercial real estate loans increased to 49% of total loans at September 30, 2007, from 47% at December 31, 2006. Real estate loans secured by residential properties increased by $7 million, or 4%. The increase for residential real estate loans was centered in relatively low loan-to-value mortgage loans rather than in equity lines, which actually declined by $7 million.

Agricultural production loans were down by $1 million, or 7%. Ag production balances include close to $11 million outstanding to a potential problem borrower, although a bumper crop and favorable market conditions have eased our concerns somewhat. That borrower is currently paying as agreed and a large portion of the balance will likely be paid down late this year or early next year, although no guarantee can be provided that we will continue to receive the timely payment of principal and interest.

As shown above, the sale of our credit card portfolio in June 2007 reduced consumer credit card balances to zero. The loans that were sold also included about $3 million in balances outstanding on business credit cards that were classified as commercial loans, which had a negative impact on year-to-date growth in commercial and industrial loans. Commercial loans increased only nominally during the first nine months of 2007. SBA loan balances fell by $5 million, or 20%, while direct finance leases grew by about $2 million, or 8%.

Table of Contents

Although not reflected in the loan totals above, from time to time the Company originates and sells agricultural and residential mortgage loans to certain other investors, and we currently provide servicing for a small number of SBA loans and agricultural mortgage loans. The balance of loans serviced for others, including participations sold, was $9 million at September 30, 2007 as compared to $17 million at December 31, 2006, a fairly significant drop due mainly to a pay-down on a large agricultural mortgage loan.

OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company makes commitments to extend credit as long as there are no violations of any conditions established in the outstanding contractual arrangement. Unused commitments to extend credit totaled $224 million at September 30, 2007 as compared to $301 million at December 31, 2006, although it is expected that not all of these commitments will ultimately be drawn down. The drop in unused commitments is due to the elimination of $40 million in unutilized credit card lines and the slowdown in construction lending. Unused commitments represented approximately 25% of gross loans outstanding at September 30, 2007, and 34% as of December 31, 2006. In addition to unused loan commitments, the Company had letters of credit totaling $20 million at September 30, 2007 and $29 million at December 31, 2006. This represents 8% of total commitments as of September 30, 2007 and 9% at December 31, 2006.

The effect on the Company s revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. For more information regarding the Company s off-balance sheet arrangements, see Note 8 to the financial statements located elsewhere herein.

NONPERFORMING ASSETS

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; loans 90 days or more past due and still accruing interest (although loans are generally placed on non-accrual status when they become 90 days past due, whether or not interest is still being collected); restructured loans where the terms of repayment have been renegotiated resulting in a deferral of interest or principal; and foreclosed assets, including OREO. Management s classification of a loan as non-accrual or restructured is an indication that there is reasonable doubt as to the Company s ability to collect principal or interest on the loan. At that point, the Company stops accruing income from the interest on the loan, reverses any interest that has been accrued but is not yet collected, and recognizes interest income only when cash interest payments are received and as long as the collection of all outstanding principal is not in doubt. These loans may or may not be collateralized, but in all cases collection efforts are continuously pursued. The following table presents comparative data for the Company s nonperforming assets:

Table of Contents

Non-performing Assets

(dollars in thousands, unaudited)

	September 30 2007	December 31 2006	September 30 2006
NON-ACCRUAL LOANS:			
Agricultural	$	$	$
Commercial and industrial		370	8
Real Estate			
Secured by commercial/professional office properties including construction and development	983		21
Secured by residential properties	218		194
Secured by farmland			
Held for sale			
TOTAL REAL ESTATE	1,201		215
Small Business Administration loans	24	262	312
Consumer loans	21		