Oak Valley Bancorp
Form 10-Q
May 14, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended March 31, 2012

OR

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

California	**26-2326676**

State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

Issuer s telephone number

Not applicable

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

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 7,880,780 shares of common stock outstanding as of April 30, 2012.

Table of Contents

Oak Valley Bancorp

March 31, 2012

Table of Contents

Table of Contents

PART I FINANCIAL STATEMENTS

Item 1. Consolidated Financial Statements (Unaudited)

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS

AT MARCH 31, 2012 (UNAUDITED) AND DECEMBER 31, 2011 (AUDITED)

		March 31, 2012		December 31, 2011
ASSETS				
Cash and due from banks	$	65,337,995	$	73,189,775
Federal funds sold		4,110,000		27,895,000
Cash and cash equivalents		69,447,995		101,084,775
Securities available for sale		105,084,610		89,694,859
Loans, net of allowance for loan loss of $7,792,147 and $8,609,174 at March 31, 2012 and December 31, 2011, respectively		384,218,846		386,958,076
Bank premises and equipment, net		13,293,112		13,499,285
Other real estate owned		0		244,375
Interest receivable and other assets		21,468,068		20,690,288
	$	593,512,631	$	612,171,658
LIABILITIES AND SHAREHOLDERS EQUITY				
Deposits	$	518,727,291	$	536,204,003
Interest payable and other liabilities		3,193,122		2,565,649
Federal Home Loan Bank advances		0		3,000,000
Total liabilities		521,920,413		541,769,652
Commitments and contingencies				
Shareholders equity				
Series B Preferred stock, no par value; $1,000 per share liquidation preference, 10,000,000 shares authorized and 13,500 issued and outstanding at March 31, 2012 and December 31, 2011		13,500,000		13,500,000
Common stock, no par value; 50,000,000 shares authorized, 7,883,780 and 7,718,469 shares issued and outstanding at March 31, 2012 and December 31, 2011, respectively		23,562,196		23,453,443
Additional paid-in capital		2,186,111		2,128,700
Retained earnings		29,921,912		28,629,757
Accumulated other comprehensive income, net of tax		2,421,999		2,690,106
Total shareholders equity		71,592,218		70,402,006

	$	593,512,631	$	612,171,658

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

Table of Contents

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2012 AND MARCH 31, 2011

	THREE MONTHS ENDED MARCH 31, 2012	2011
INTEREST INCOME		
Interest and fees on loans	$ 5,715,043	$ 5,941,678
Interest on securities available for sale	833,685	694,075
Interest on federal funds sold	5,067	15,218
Interest on deposits with banks	29,806	16,671
Total interest income	6,583,601	6,667,642
INTEREST EXPENSE		
Deposits	315,217	440,520
FHLB advances	4,707	21,674
Total interest expense	319,924	462,194
Net interest income	6,263,677	6,205,448
PROVISION FOR LOAN LOSSES	300,000	600,000
Net interest income after provision for loan losses	5,963,677	5,605,448
OTHER INCOME		
Service charges on deposits	281,078	258,095
Earnings on cash surrender value of life insurance	105,000	128,298
Mortgage commissions	47,409	9,873
Other	397,739	274,975
Total non-interest income	831,226	671,241
OTHER EXPENSES		
Salaries and employee benefits	2,575,563	2,333,990
Occupancy expenses	750,874	656,530
Data processing fees	277,861	258,635
OREO expenses	20,074	248,778
Regulatory assessments (FDIC & DFI)	117,000	198,000
Other operating expenses	855,392	829,904
Total non-interest expense	4,596,764	4,525,837
Net income before provision for income taxes	2,198,139	1,750,852
PROVISION FOR INCOME TAXES	737,234	585,376
NET INCOME	$ 1,460,905	$ 1,165,476
Preferred stock dividends and accretion	168,750	210,411
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$ 1,292,155	$ 955,065
NET INCOME PER COMMON SHARE	$ 0.17	$ 0.12
NET EARNINGS PER DILUTED COMMON SHARE	$ 0.17	$ 0.12

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

Table of Contents

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2012 AND MARCH 31, 2011

	THREE MONTHS ENDED MARCH 31, 2012	2011
Net income	$ 1,460,905	$ 1,165,476
Available for sale securities:		
Gross unrealized (loss) gain arising during the year	(434,031)	201,009
Reclassification adjustment for gains realized in net income	(21,547)	(25,884)
Income tax benefit (expense)	187,471	(72,063)
Other comprehensive (loss) income	(268,107)	103,062
Comprehensive income	$ 1,192,798	$ 1,268,538

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

Table of Contents

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

FOR THE YEAR ENDED DECEMBER 31, 2011 AND THE THREE-MONTH PERIOD ENDED MARCH 31, 2012 (UNAUDITED)

YEAR ENDED DECEMBER 31, 2011 AND THREE MONTHS ENDED MARCH 31, 2012

	Common Stock Shares	Common Stock Amount	Preferred Stock Shares	Preferred Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balances, January 1, 2012	7,702,127	$ 24,003,549	13,500	$ 13,013,945	$ 2,080,218	$ 24,016,466	$ 1,543,554	$ 64,657,732
Stock options exercised	3,037	$ 9,894						$ 9,894
Restricted stock issued	13,305							
Repurchase of Series A preferred stock			(13,500)	$ (13,500,000)				(13,500,000)
Series B preferred stock issued			13,500	13,500,000				13,500,000
Preferred stock accretion				486,055		$ (486,055)		0
Preferred stock dividend payments						(761,249)		(761,249)
Payment to repurchase U.S. Treasury Warrant		(560,000)						(560,000)
Stock based compensation					48,482			48,482
Other comprehensive income							1,146,552	1,146,552
Net income						5,860,595		5,860,595
Balances, December 31, 2011	7,718,469	$ 23,453,443	13,500	$ 13,500,000	$ 2,128,700	$ 28,629,757	$ 2,690,106	$ 70,402,006
Stock options exercised	27,436	$ 108,753						$ 108,753
Tax benefit on stock options exercised					32,842			32,842
Restricted stock issued	137,875							0
Preferred stock dividend payments						(168,750)		(168,750)
Stock based compensation					24,569			24,569
Other comprehensive loss							(268,107)	(268,107)
Net income						1,460,905		1,460,905
Balances, March 31, 2012	7,883,780	$ 23,562,196	13,500	$ 13,500,000	$ 2,186,111	$ 29,921,912	$ 2,421,999	$ 71,592,218

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

Table of Contents

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2012 AND MARCH 31, 2011

	THREE MONTHS ENDED MARCH 31, 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,460,905	$ 1,165,476
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision for loan losses	300,000	600,000
Decrease in deferred fees/costs, net	(61,865)	(18,995)
Depreciation	281,490	225,471
Amortization of investment securities, net	38,817	532
Stock based compensation	24,569	12,000
Excess tax benefits from stock-based payment arrangements	(32,842)	0
Gain on sale of premises and equipment	(21,875)	0
OREO write downs and losses/(gain) on sale	(3,548)	219,166
Gain on called available for sale securities	(21,547)	(25,884)
Earnings on cash surrender value of life insurance	(105,000)	(128,298)
Increase in interest payable and other liabilities	627,473	349,490
Increase in interest receivable	(115,485)	(84,647)
Increase in other assets	(470,831)	(7,249)
Net cash from operating activities	1,900,261	2,307,062
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(21,970,982)	(22,085,657)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	6,108,382	1,881,943
Net decrease in loans	2,501,095	8,842,258
Purchase of FRB Stock	(1,450)	0
Redemption of FHLB stock	135,300	134,000
Proceeds from sale of OREO	247,923	0
Proceeds from sales of premises and equipment	21,875	0
Net purchases of premises and equipment	(75,317)	(78,384)
Net cash used in investing activities	(13,033,174)	(11,305,840)
CASH FLOWS FROM FINANCING ACTIVITIES:		
FHLB payments	(3,000,000)	0
Preferred stock dividend payment	(168,750)	(168,750)
Net (decrease) increase in demand deposits and savings accounts	(17,538,864)	16,102,250
Net increase (decrease) in time deposits	62,152	(7,200,472)
Excess tax benefits from stock-based payment arrangements	32,842	0
Proceeds from sale of common stock and exercise of stock options	108,753	9,894
Net cash (used in) from financing activities	(20,503,867)	8,742,922
NET DECREASE IN CASH AND CASH EQUIVALENTS	(31,636,780)	(255,856)
CASH AND CASH EQUIVALENTS, beginning of period	101,084,775	68,936,916
CASH AND CASH EQUIVALENTS, end of period	$ 69,447,995	$ 68,681,060
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		

Cash paid during the period for:				
Interest	$	339,172	$	477,548
Income taxes	$	0	$	221,119
NON-CASH INVESTING ACTIVITIES:				
Change in unrealized (loss) gain on available-for-sale securities	$	(455,578)	$	175,125
NON-CASH FINANCING ACTIVITIES:				
Accretion of preferred stock	$	0	$	41,662

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

Table of Contents

OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

On July 3, 2008 (the Effective Date), a bank holding company reorganization was completed whereby Oak Valley Bancorp (the Company) became the parent holding company for Oak Valley Community Bank (the Bank). On the Effective Date, each outstanding share of the Bank was converted into one share of Oak Valley Bancorp and the Bank became a wholly-owned subsidiary of the holding company.

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America (GAAP) and with general practices within the banking industry. In preparing financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the estimation of compensation expense related to stock options granted to employees and directors, and valuation allowances associated with deferred tax assets, the recognition of which are based on future taxable income.

The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three month period ended March 31, 2012 are not necessarily indicative of the results of a full year s operations. Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders equity. For further information, refer to the audited consolidated financial statements and footnotes included in the Company s Form 10-K for the year ended December 31, 2011.

NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-04 *Fair Value Measurement* (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) by changing the wording used to describe many of the requirements in U.S GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanation on how to measure fair value but do not require any additional fair value measurements and does not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity s shareholders equity; and disclosures requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For public entities, ASU 2011-04 is effective during interim and annual periods beginning after December 15, 2011. There was no significant impact on the Company s financial position or results of operations as a result of adopting this ASU.

In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income* (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders equity. Any adjustments for items are that reclassified from other comprehensive income to net income are to be presented on the face of the entities financial statement regardless the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years, and interim periods beginning on or after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. The ASU defers indefinitely the requirement to present reclassification adjustments and the effect of those reclassification adjustments on the face of the financial statements where net income is presented, by component of net income, and on the face of the financial statements where other comprehensive income is presented, by component of other comprehensive income. The adoption of the ASUs did not have a material impact on the Company s consolidated financial statements.

Table of Contents

In December 2011, the FASB issued ASU No. 2011-11, *Disclosures about Offsetting Assets and Liabilities.* The update requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally enforceable right of setoff and intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company s consolidated financial statements.

NOTE 3 PREFERRED STOCK REPURCHASE AND WARRANT REDEMPTION

In August 2011, The Company repurchased the $13,500,000 of Series A Preferred Stock originally issued to the U.S. Treasury in December 2008 in connection with the Company s participation in the Capital Purchase Program (CPP). The Company simultaneously issued $13,500,000 in Series B Preferred Stock to the U.S. Treasury under the Small Business Lending Funding (SBLF) program. Subsequently, the Company fully redeemed a warrant to purchase 350,346 shares of its Common Stock, at the exercise price of $5.78 per share that the Company had granted to the U.S. Treasury pursuant to the CPP, for a purchase price of $560,000, which settled in September 2011. So long as the preferred stock remains outstanding under SBLF, it will pay quarterly cumulative dividends at a variable rate between 1% and 5% per year for the first 2.5 years depending on growth of our small business loan portfolio. If there is no loan growth after 2.5 years, the dividend rate could increase to 7% and if the preferred stock remains outstanding after 4.5 years, the rate increases to 9%, regardless of loan growth.

NOTE 4 SECURITIES

The amortized cost and estimated fair values of debt securities as of March 31, 2012 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
Available-for-sale securities:				
U.S. agencies	$ 59,906,876	2,481,613	$ (125,112)	$ 62,263,377
Collateralized mortgage obligations	10,970,471	636,179		11,606,650
Municipalities	22,180,784	1,370,987	(184,564)	23,367,207
SBA Pools	1,221,868		(599)	1,221,269
Corporate debt	3,898,994		(68,917)	3,830,077
Mutual Fund	2,789,598	15,625	(9,193)	2,796,030
	$ 100,968,591	$ 4,504,404	$ (388,385)	$ 105,084,610

Table of Contents

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2012.

	Less than 12 months		12 months or more		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. agencies	$ 15,172,301	$ (125,112)	$		$ 15,172,301	$ (125,112)
Collateralized mortgage obligations						
Municipalities	7,823,553	(184,564)			7,823,553	(184,564)
SBA Pools	1,216,426	(599)			1,216,426	(599)
Corporate debt	3,830,077	(68,917)			3,830,077	(68,917)
Mutual Fund	990,807	(9,193)			990,807	(9,193)
Total temporarily impaired securities	$ 29,033,164	$ (388,385)	$	$	$ 29,033,164	$ (388,385)

At March 31, 2012, there were no securities in an unrealized loss position for greater than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The amortized cost and estimated fair value of debt securities at March 31, 2012, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	**Fair Value**
Available-for-sale securities:		
Due in one year or less	$ 11,497,415	$ 11,473,757
Due after one year through five years	12,210,183	13,317,075
Due after five years through ten years	29,938,511	31,102,342
Due after ten years	47,322,482	49,191,436
	$ 100,968,591	$ 105,084,610

The amortized cost and estimated fair values of debt securities as of December 31, 2011, are as follows:

	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Market Value**
Available-for-sale securities:				
U.S. agencies	$ 52,101,177	2,722,817	$ (14,686)	$ 54,809,308
Collateralized mortgage obligations	11,366,368	728,104		12,094,472
Municipalities	15,660,035	1,312,377	(370)	16,972,042
SBA Pools	1,236,366	55		1,236,421

Corporate debt		2,000,000		0		(185,716)		1,814,284
Mutual Fund		2,759,316		17,188		(8,172)		2,768,332
	$	85,123,262	$	4,780,541	$	(208,944)	$	89,694,859

Table of Contents

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2011.

	Less than 12 months		12 months or more		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. agencies	$ 2,985,314	$ (14,686)	$		$ 2,985,314	$ (14,686)
Collateralized mortgage obligations						
Municipalities	561,580	(370)			561,580	(370)
SBA Pools						
Corporate debt	1,814,284	(185,716)			1,814,284	(185,716)
Mutual Fund	991,828	(8,172)			991,828	(8,172)
Total temporarily impaired securities	$ 6,353,006	$ (208,944)	$	$	$ 6,353,006	$ (208,944)

At December 31, 2011, there were no securities in an unrealized loss position for greater than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The Company recognized a gain of $21,547 for the three month period ended March 31, 2012, on certain available-for-sale securities that were partially called, which compares to $25,884 in the same period of 2011. There were no sales of available-for-sale securities during the first three months of 2012 and 2011.

Securities carried at $53,745,429 and $53,419,019 at March 31, 2012 and December 31, 2011, respectively, were pledged to secure deposits of public funds.

NOTE 5 LOANS

The Company s customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of March 31, 2012, approximately 84% of the Company s loans are commercial real estate loans which includes construction loans. Approximately 8% of the Company s loans are for general commercial uses including professional, retail, and small business. Additionally, 6% of the Company s loans are for residential real estate and other consumer loans. The remaining 2% are agriculture loans.

Loan totals were as follows:

	March 31, 2012	**December 31, 2011**

Commercial real estate:		
Commercial real estate- construction	$ 14,156,962	$ 14,595,324
Commercial real estate- mortgages	284,397,096	284,263,685
Land	10,195,637	10,635,954
Farmland	21,017,090	20,549,849
Commercial and industrial	32,329,830	32,017,744
Consumer	1,045,006	1,212,986
Consumer residential	22,853,820	23,870,519
Agriculture	6,588,121	9,055,622
Total loans	392,583,562	396,201,683
Less:		
Deferred loan fees and costs, net	(572,568)	(634,433)
Allowance for loan losses	(7,792,148)	(8,609,174)
Net loans	$ 384,218,846	$ 386,958,076

Table of Contents

Loan Origination/Risk Management. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower s ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower s management possesses sound ethics and solid business acumen, the Company s management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At March 31, 2012, approximately 37.1% of the outstanding principal balance of the Company s commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Company originates consumer loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans follow bank policy, which include, but are not limited to, a maximum loan-to-value percentage of 80%, a maximum housing and total debt ratio of 36% and 42%, respectively and other specified credit and documentation requirements.

The Company maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company s policies and procedures.

Table of Contents

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Non-accrual loans, segregated by class of loans, were as follows:

	March 31, 2012	December 31, 2011
Commercial real estate:		
Commercial real estate- construction	$ 290,867	$ 179,262
Commercial real estate- mortgages	2,994,798	3,671,693
Land	3,266,962	3,277,463
Farmland	0	0
Commercial and industrial	103,170	104,481
Consumer	0	0
Consumer residential	0	0
Agriculture	0	0
Total non-accrual loans	$ 6,655,797	$ 7,232,899

Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income of approximately $154,000 in three month period ended March 31, 2012, as compared to $181,000 in the same period of 2011.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of March 31, 2012:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing
March 31, 2012							
Commercial real estate:							
Commercial R.E. - construction	$ 58,261	$ 0	$ 290,867	$ 349,128	$ 13,807,834	$ 14,156,962	$ 0
Commercial R.E. - mortgages	666,851	0	2,577,216	3,244,067	281,153,029	284,397,096	0
Land	1,067,726	1,864,502	2,580,230	5,512,458	4,683,179	10,195,637	0
Farmland	0	0	0	0	21,017,090	21,017,090	0
Commercial and industrial	0	351,192	79,059	430,251	31,899,579	32,329,830	0
Consumer	0	0	0	0	1,045,006	1,045,006	0
Consumer residential	0	0	0	0	22,853,820	22,853,820	0
Agriculture	0	0	0	0	6,588,121	6,588,121	0
Total	$ 1,792,838	$ 2,215,694	$ 5,527,372	$ 9,535,904	$ 383,047,658	$ 392,583,562	$ 0

13

Table of Contents

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2011:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Greater Than 90 Days Past Due and Still Accruing
December 31, 2011							
Commercial real estate:							
Commercial R.E. - construction	$ 0	$ 0	$ 179,263	$ 179,263	$ 14,416,061	$ 14,595,324	$ 0
Commercial R.E. - mortgages	424,683	0	3,671,693	4,096,376	280,167,309	284,263,685	0
Land	0	0	2,580,231	2,580,231	8,055,723	10,635,954	0
Farmland	0	0	0	0	20,549,849	20,549,849	0
Commercial and industrial	0	79,059	0	79,059	31,938,685	32,017,744	0
Consumer	16,419	0	0	16,419	1,196,567	1,212,986	0
Consumer residential	0	0	0	0	23,870,519	23,870,519	0
Agriculture	0	0	0	0	9,055,622	9,055,622	0
Total	$ 441,102	$ 79,059	$ 6,431,187	$ 6,951,348	$ 389,250,335	$ 396,201,683	$ 0

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. There was no interest income realized on impaired loans for the three months ended March 31, 2012 and 2011. Average recorded investment in impaired loans was $6,944,000 for the three months ended March 31, 2012 as compared to $11,391,000 for the same period of 2011. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Table of Contents

Impaired loans as of March 31, 2012 and December 31, 2011 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired.

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
March 31, 2012						
Commercial real estate:						
Commercial R.E. - construction	$ 357,467	$ 0	$ 290,867	$ 290,867	$ 1,656	$ 235,064
Commercial R.E. - mortgages	4,887,323	2,577,217	417,581	2,994,798	83,721	3,333,246
Land	7,659,989	686,732	2,580,230	3,266,962	266,761	3,272,213
Farmland	0	0	0	0	0	0
Commercial and Industrial	116,299	103,170	0	103,170	0	103,826
Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0
Agriculture	0	0	0	0	0	0
Total	$ 13,021,078	$ 3,367,119	$ 3,288,678	$ 6,655,797	$ 352,138	$ 6,944,349
December 31, 2011						
Commercial real estate:						
Commercial R.E. - construction	$ 245,862	$ 0	$ 179,262	$ 179,262	$ 5,984	$ 1,177,407
Commercial R.E. - mortgages	4,469,681	3,671,693	0	3,671,693	0	4,111,549
Land	7,659,990	697,232	2,580,231	3,277,463	544,630	3,329,784
Farmland	0	0	0	0	0	0
Commercial and Industrial	116,867	104,481	0	104,481	0	36,655
Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0
Agriculture	0	0	0	0	0	0
Total	$ 12,492,400	$ 4,473,406	$ 2,759,493	$ 7,232,899	$ 550,614	$ 8,655,395

Troubled Debt Restructurings In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company s internal underwriting policy.

At March 31, 2012, there were 5 loans and leases that were considered to be troubled debt restructurings, all of which are considered nonaccrual totaling $3,582,000. At March 31, 2012 and December 31, 2011 there were unfunded commitments of $1,497,000 and $1,644,000, respectively, on one loan classified as a troubled debt restructure because of an agreement with a borrower to continue advancing funds and covering overhead costs on a residential development project. The Company will receive proceeds to pay down the principal as the residential properties sell.

The Company has allocated $268,000 and $551,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of March 31, 2012 and December 31, 2011, respectively. The Company had commitments to lend an additional $1,497,000 and $1,644,000 to one of these borrowers as of March 31, 2012 and December 31, 2011, respectively, as described above.

During the three-month period ended March 31, 2012, there were no loans modified as troubled debt restructurings. If a loan modification is granted, the modification of the terms of such loans typically includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan is conceded.

Since there was no troubled debt restructurings during the three-month period ended March 31, 2012, there was no increase in the allowance for loan losses as a result of loan modifications and there were no charge offs as a result of loan modifications.

Table of Contents

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three month period ended March 31, 2012.

	Three Months Ended March 31, 2012		
	Number of Loans		**Recorded Investment**
Commercial real estate:			
Commercial R.E. - construction	0	$	0
Commercial R.E. - mortgages	0		0
Land	1		571,594
Farmland	0		0
Commercial and Industrial	0		0
Consumer	0		0
Consumer residential	0		0
Agriculture	0		0
Total	1	$	571,594

A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

Quality ratings (Risk Grades) are assigned to all commitments and stand-alone notes. Risk grades define the basic characteristics of commitments or stand-alone note in relation to their risk. All loans are graded using a system that maximizes the loan quality information contained in loan review grades, while ensuring that the system is compatible with the grades used by bank examiners.

We grade loans using the following letter system:

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

1. Exceptional Loan - Loans with A+ credits that contain very little, if any, risk. Grade 1 loans are considered Pass. To qualify for this rating, the following characteristics must be present:

- A high level of liquidity and whose debt-servicing capacity exceeds expected obligations by a substantial margin.
- Where leverage is below average for the industry and earnings are consistent or growing without severe vulnerability to economic cycles.
- Also included in this rating (but not mandatory unless one or more of the preceding characteristics are missing) are loans that are fully secured and properly margined by our own time instruments or U.S. blue chip securities. To be properly margined cash collateral must be equal to, or greater than, 110% of the loan amount.

2. Quality Loan - Loans with excellent sources of repayment that conform in all respects to bank policy and regulatory requirements. These are also loans for which little repayment risk has been identified. No credit or collateral exceptions. Grade 2 loans are considered Pass. Other factors include:

- Unquestionable debt-servicing capacity to cover all obligations in the ordinary course of business from well-defined primary and secondary sources.
- Consistent strong earnings.
- A solid equity base.

3A. Better than Acceptable Loan - In the interest of better delineating the loan portfolio s true credit risk for reserve allocation, further granularity has been sought by splitting the grade 3 category into three classifications. The distinction between the three are bank-defined guidelines and represent a further refinement of the regulatory definition of a pass, or grade 3 loan. Grade 3A is the stronger third of the pass category, but is not strong enough to be a grade 2 and is characterized by:

- Strong earnings with no loss in last three years and ample cash flow to service all debt well above policy guidelines.
- Long term experienced management with depth and defined management succession.

Table of Contents

- The loan has no exceptions to policy.
- Loan-to-value on real estate secured transactions is 10% to 20% less than policy guidelines.
- Very liquid balance sheet that may have cash available to pay off our loan completely.
- Little to no debt on balance sheet.

3B. Acceptable Loan - 3B loans are simply defined as all loans that are less qualified than 3A loans and are stronger than 3C loans. These loans are characterized by acceptable sources of repayment that conform to bank policy and regulatory requirements. Repayment risks are acceptable for these loans. Credit or collateral exceptions are minimal, are in the process of correction, and do not represent repayment risk. These loans:

- Are those where the borrower has average financial strengths, a history of profitable operations and experienced management.
- Are those where the borrower can be expected to handle normal credit needs in a satisfactory manner.

3C. Marginally Acceptable - 3C loans have similar characteristics as that of 3Bs with the following additional characteristics: Requires collateral. A credit facility where the borrower has average financial strengths, but usually lacks reliable secondary sources of repayment other than the subject collateral. Other common characteristics can include some or all of the following: minimal background experience of management, lacking continuity of management, a start-up operation, erratic historical profitability (acceptable reasons-well identified), lack of or marginal sponsorship of guarantor, and government guaranteed loans.

4W Watch Acceptable - Watch grade will be assigned to any credit that is adequately secured and performing but monitored for a number of indicators. These characteristics may include any unexpected short-term adverse financial performance from budgeted projections or prior period s results (i.e., declining profits, sales, margins, cash flow, or increased reliance on leverage, including adverse balance sheet ratios, trade debt issues, etc.). Additionally, any managerial or personal problems of company management, decline in the entire industry or local economic conditions failure to provide financial information or other documentation as requested; issues regarding delinquency, overdrafts, or renewals; and any other issues that cause concern for the company. Loans to individuals or loans supported by guarantors with marginal net worth and/or marginal collateral. Weakness identified in a Watch credit is short-term in nature. Loans in this category are usually accounts the Company would want to retain providing a positive turnaround can be expected within a reasonable time frame. Grade 4 loans are considered Pass.

5 Other Loans Especially Mentioned (Special Mention) - A special mention extension of credit is defined as having potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may, at some future date result in the deterioration of the repayment prospects for the credit or the institution s credit position. Extensions of credit that might be detailed in this category include the following:

- The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.
- Questions exist regarding the condition of and/or control over collateral.

•Economic or market conditions may unfavorably affect the obligor in the future.

•A declining trend in the obligor s operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized.

_6_ _Substandard Loan_ - A substandard extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

_7_ _Doubtful Loan_ - An extension of credit classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Company. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss. A credit classified as doubtful should be resolved within a reasonable period of time. Reasonable is generally defined as the period between examinations. In other words, a credit classified doubtful at an examination should be cleared up before the next exam. However, there may be situations that warrant continuation of the doubtful classification a while longer.

_8._ _Loss_ - Extensions of credit classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off, even though partial recovery may be affected in the future. It should not be the Company s practice to attempt long-term recoveries while the credit remains on the books. Losses should be taken in the period in which they surface as uncollectible.

Table of Contents

The following table presents weighted average risk grades of our loan portfolio:

	March 31, 2012 Weighted Average Risk Grade	December 31, 2011 Weighted Average Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.56	3.52
Commercial real estate - mortgages	3.24	3.26
Land	4.82	4.75
Farmland	3.38	3.40
Commercial and Industrial	3.14	3.21
Consumer	2.64	2.76
Consumer residential	3.11	3.10
Agriculture	3.31	3.23
Total gross loans	3.28	3.30

The following table presents risk grade totals by class of loans as of March 31, 2012. Risk grades 1 through 4 have been aggregated in the Pass line.

Dollars in thousands	Commercial R.E. Construction	Commercial R.E. Mortgages	Land	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
March 31, 2012									
Pass	$ 13,866,095	$ 267,048,227	$ 3,996,447	$ 19,680,236	$ 31,263,756	$ 1,027,870	$ 22,459,853	$ 5,905,546	$ 365,248,030
Special mention		7,848,738			142,525				7,991,263
Substandard	290,867	9,500,131	6,199,190	1,336,854	923,549	17,136	393,967	682,575	19,344,269
Doubtful									
Total loans	$ 14,156,962	$ 284,397,096	$ 10,195,637	$ 21,017,090	$ 32,329,830	$ 1,045,006	$ 22,853,820	$ 6,588,121	$ 392,583,562
December 31, 2011									
Pass	$ 14,416,062	$ 264,913,517	$ 4,419,659	$ 19,188,322	$ 31,000,530	$ 1,179,624	$ 23,475,447	$ 8,357,801	$ 366,950,962
Special mention		8,684,736			78,011				8,762,747
Substandard	179,262	10,665,432	6,216,295	1,361,527	939,203	16,943	395,072	697,821	20,471,555
Doubtful						16,419			16,419
Total loans	$ 14,595,324	$ 284,263,685	$ 10,635,954	$ 20,549,849	$ 32,017,744	$ 1,212,986	$ 23,870,519	$ 9,055,622	$ 396,201,683

Allowance for Loan Losses. The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Company s allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Company s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

Table of Contents

The level of the allowance reflects management s continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management s judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company s control, including, among other things, the performance of the Company s loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company s allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor s ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 5 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower s ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower s industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Company s pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Company s lending management and staff; (ii) the effectiveness of the Company s loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of rising interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a general allocation matrix to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

Table of Contents

The following table details activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2012 and 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

Allowance for Loan Losses

For the Three Months Ended March 31, 2012 and 2011

	Commercial Real Estate	Commercial and industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Three Months Ended March 31, 2012							
Beginning balance	$ 6,969,004	$ 606,307	$ 65,060	$ 347,905	$ 363,174	$ 257,724	$ 8,609,174
Charge-offs	(1,106,790)	0	(18,642)	0	0	0	(1,125,432)
Recoveries	4,707	0	1,835	1,864		0	8,406
Provision	622,611	(51,387)	1,698	27,309	(65,317)	(234,914)	300,000
Ending balance	$ 6,489,532	$ 554,920	$ 49,951	$ 377,078	$ 297,857	$ 22,810	$ 7,792,148
Three Months Ended March 31, 2011							
Beginning balance	$ 6,577,011	$ 686,303	$ 61,115	$ 375,349	$ 152,526	$ 402,625	$ 8,254,929
Charge-offs	(55,039)	(35,000)	(1,865)	0	0	0	(91,904)
Recoveries	0	0	1,983	18	0	0	2,001
Provision	715,927	42,776	(9,591)	(100,508)	(26,303)	(22,301)	600,000
Ending balance	$ 7,237,899	$ 694,079	$ 51,642	$ 274,859	$ 126,223	$ 380,324	$ 8,765,026

The following table details the allowance for loan losses and ending gross loan balances as of March 31, 2012 and December 31, 2011, summarized by collective and individual evaluation methods of impairment.

	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
March 31, 2012							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 352,138	$ 0	$ 0	$ 0	$ 0	$ 0	$ 352,138
Collectively evaluated for impairment	6,137,394	554,920	49,951	377,078	297,857	22,810	7,440,010
	$ 6,489,532	$ 554,920	$ 49,951	$ 377,078	$ 297,857	$ 22,810	$ 7,792,148
Ending gross loan balances:							
Individually evaluated for impairment	$ 6,552,627	$ 103,170	$ 0	$ 0	$ 0	$ 0	$ 6,655,797
Collectively evaluated for impairment	323,214,158	32,226,660	1,045,006	22,853,820	6,588,121	0	385,927,765
	$ 329,766,785	$ 32,329,830	$ 1,045,006	$ 22,853,820	$ 6,588,121	$ 0	$ 392,583,562
December 31, 2011							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 550,614	$ 0	$ 0	$ 0	$ 0	$ 0	$ 550,614
	6,418,390	606,307	65,060	347,905	363,174	257,724	8,058,560

Collectively evaluated for impairment							
	$ 6,969,004	$ 606,307	$ 65,060	$ 347,905	$ 363,174	$ 257,724	$ 8,609,174
Ending balances of loans:							
Individually evaluated for impairment	$ 7,128,418	$ 104,481	$ 0	$ 0	$ 0	$ 0	$ 7,232,899
Collectively evaluated for impairment	322,916,394	31,913,263	1,212,986	23,870,519	9,055,622	0	388,968,784
	$ 330,044,812	$ 32,017,744	$ 1,212,986	$ 23,870,519	$ 9,055,622	$ 0	$ 396,201,683

Table of Contents

Changes in the reserve for off-balance-sheet commitments were as follows:

	THREE MONTHS ENDED MARCH 31, 2012		2011	
Balance, beginning of year	$	119,202	$	157,001
Provision Charged to Operations for Off Balance Sheet		(15,614)		(36,231)
Balance, end of year	$	103,588	$	120,770

The method for calculating the reserve for off-balance-sheet loan commitments is based on an reserve percentage which is less than other outstanding loan types because they are at a lower risk level. This reserve percentage, based on many factors including historical losses and existing economic conditions, is evaluated by management periodically and is applied to the total undisbursed loan commitment balance to calculate the reserve for off-balance-sheet commitments. Reserves for off-balance-sheet commitments are recorded in interest payable and other liabilities on the condensed consolidated balance sheets.

At March 31, 2012 and December 31, 2011, loans carried at $392,583,562 and $396,201,683, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

Table of Contents

NOTE 6 OTHER REAL ESTATE OWNED

As of March 31, 2012, the Company owned one property with a carrying value of zero that was classified as other real estate owned, as compared to two properties with outstanding balances of $244,375 as of December 31, 2011. Each of these properties was acquired through loan foreclosure.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of carrying amount of the loan or fair value of the property at the date of foreclosure less selling costs. Subsequent to foreclosure, valuations are periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure. Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

NOTE 7 OTHER POST-RETIREMENT BENEFIT PLANS

During January 2008, the Company awarded certain officers a salary continuation plan (the Plan). Under the Plan, the participants will be provided with a fixed annual retirement benefit for twenty years after retirement. The Company is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Company purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Company is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Company and are available to satisfy the Company s general creditors.

During January 2008 the Company awarded two of its directors a director retirement plan (DRP). Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Company is also responsible for certain pre-retirement death benefits under the DRP. In connection with the implementation of the DRP, the Company purchased single premium life insurance policies on the life of each director covered under the DRP. The Company is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Company and are available to satisfy the Company s general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Company s current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years. The salary continuation liability as of March 31, 2012 and December 31, 2011 was $1,582,424 and $1,511,486, respectively, and is reported in interest payable and other liabilities on the condensed consolidated balance sheets.

During January 2008, the Company purchased $4.7 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with certain officers and directors. In connection with the implementation of the split-dollar agreements, the Company purchased single premium life insurance policies on the life of each of the officers and directors covered by the split-dollar life insurance agreements. The Company is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies recorded in other assets on the condensed consolidated balance sheet was $11,360,877 and $11,255,877 at March 31, 2012 and December 31, 2011, respectively.

NOTE 8 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Fair values of financial instruments The consolidated financial statements include various estimated fair value information as of March 31, 2012 and December 31, 2011. Such information, which pertains to the Company s financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

Fair value measurements defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1: Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Table of Contents

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company s quarterly valuation process.

Following is a description of valuation methodologies used for assets and liabilities in the tables below:

Cash and cash equivalent The carrying amounts of cash and cash equivalents approximate their fair value and are considered a level 1 valuation.

Available-for-sale securities - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security s credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Restricted Equity Securities- The carrying amounts of the stock the Company s owns in FRB and FHLB approximate their fair value and are considered a level 1 valuation.

Loans receivable For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. The Company s fair value model takes into account many inputs including current market rates on new loans, the U.S. treasury yield curve, LIBOR yield curve, rate floors, rate ceilings, remaining maturity, and average life based on specific loan type. Net loans are considered to be a level 3 valuation.

Deposit liabilities The fair values estimated for demand deposits (interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of the aggregate expected monthly maturities on time deposits. The fair value of deposits is determined by the Company s internal assets and liabilities modeling system that accounts for various inputs such as decay rates, rate floors, FHLB yield curve, maturities and current rates offered on new accounts. Fair value on deposits is considered a level 2 valuation.

Federal Home Loan Bank (FHLB) advances The fair value of FHLB advances is determined by the Company s internal assets and liabilities modeling system that accounts for various inputs such as maturities of specific advances and the current FHLB yield curve . Fair value on FHLB advances are considered a level 2 valuation.

Interest receivable and payable - The carrying amounts of accrued interest approximate their fair value and are considered to be a level 2 valuation.

Off-balance-sheet instruments Fair values for the Company s off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the counterparties. The Company considers the off balance sheet instruments to be a level 3 valuation.

Table of Contents

The estimated fair values of the Company s financial instruments at March 31, 2012 were as follows:

	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$ 69,447,995	$ 69,447,995	1
Securities available for sale	105,084,610	105,084,610	2
Restricted equity securities	3,859,950	3,859,950	2
Loans, net	384,218,846	398,051,108	3
Interest receivable	1,818,942	1,818,942	2
Financial liabilities:			
Deposits	(518,727,291)	(519,234,241)	3
Interest payable	(110,024)	(110,024)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(395,854)	3

The estimated fair values of the Company s financial instruments at December 31, 2011 were as follows:

	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$ 101,084,775	$ 101,084,775	1
Securities available for sale	89,694,859	89,694,859	2
Restricted equity securities	3,993,800	3,993,800	2
Loans, net	386,958,076	401,051,975	3
Interest receivable	1,703,457	1,703,457	2
Financial liabilities:			
Deposits	(536,204,003)	(536,791,880)	3
FHLB advance	(3,000,000)	(3,002,834)	2
Interest payable	(129,272)	(129,272)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(464,029)	3

Table of Contents

Assets and liabilities measured at fair value on a recurring and non-recurring basis as of March 31, 2012 and December 31, 2011 are summarized below:

	March 31, 2012	Fair Value Measurements at March 31, 2012 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	$ 62,263,377	$ 0	$ 62,263,377	$ 0
Collateralized mortgage obligations	11,606,650	0	11,606,650	0
Municipalities	23,367,207	0	23,367,207	0
SBA Pools	1,221,269	0	1,221,269	0
Corporate Debt	3,830,077	0	3,830,077	0
Mutual Fund	2,796,030	2,796,030	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans	$ 5,592,816	$ 0	$ 0	$ 5,592,816
Other real estate owned	$ 0	$ 0	$ 0	$ 0

	December 31, 2011	Fair Value Measurements at December 31, 2011 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities				
U.S. agencies	$ 54,809,308	$ 0	$ 54,809,308	$ 0
Collateralized mortgage obligations	12,094,472	0	12,094,472	0
Municipalities	16,972,042	0	16,972,042	0
SBA Pools	1,236,421	0	1,236,421	0
Corporate debt	1,814,284	0	1,814,284	0
Mutual Fund	2,768,332	2,768,332	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired Loans	$ 4,650,738	$ 0	$ 0	$ 4,650,738
Other real estate owned	$ 244,375	$ 0	$ 0	$ 244,375

Losses (gains) recognized from non-recurring fair value adjustments for the three month periods ended March 31, 2012 and 2011 are presented on the following table:

THREE MONTHS ENDED MARCH 31,

	2012	2011
Impaired loans	$ 1,106,790	$ 90,039
Other real estate owned	(3,548)	219,166
Total loss from non-recurring fair value adjustments	$ 1,103,242	$ 309,205

Table of Contents

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-sale securities - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security s credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Impaired loans - ASC Topic 820 applies to loans measured for impairment using the practical expedients permitted by ASC Topic 310, *Accounting by Creditors for Impairment of a Loan*. The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Impaired loans where an allowance is established based on the fair value of collateral less the cost related to liquidation of the collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as non-recurring Level 3. Likewise, when an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as non-recurring Level 3.

Other Real Estate Owned - Other real estate assets (OREO) acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses, subsequent to foreclosure. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy.

NOTE 9 EARNINGS PER SHARE

Earnings per share (EPS) is calculated based on the weighted average common shares outstanding during the period. Basic EPS excludes dilution and is calculated by dividing net income available to common shareholders by the weighted average common shares outstanding. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

In thousands (except share and per share amounts)	**THREE MONTHS ENDED MARCH 31, 2012**	**2011**
BASIC EARNINGS PER SHARE		
Net income available to common shareholders	$ 1,292,155	$ 955,065
Weighted average shares outstanding	7,722,609	7,711,401
Net income per common share	$ 0.17	$ 0.12

DILUTED EARNINGS PER SHARE				
Net income available to common shareholders	$	1,292,155	$	955,065
Weighted average shares outstanding		7,722,609		7,711,401
Effect of dilutive stock options		17,523		19,679
Effect of dilutive non-vested restricted shares		3,809		0
Effect of dilutive warrants		0		11,150
Weighted average shares of common stock and common stock equivalents		7,743,941		7,742,230
Net income per diluted common share	$	0.17	$	0.12

During the three month period ended March 31, 2012, anti-dilutive weighted average options to purchase 219,625 shares of common stock were outstanding with prices ranging from $7.00 to $15.67. Anti-dilutive weighted average stock options of 219,625 were outstanding during the same three month period of 2011, with prices ranging from $7.05 to $15.67. These options were not included in the computation of diluted EPS because the options exercise price was greater than the average market price of the common shares. These options begin to expire in 2013.

Table of Contents

Weighted average warrants of 350,346 issued to the U.S. Treasury Capital Purchase Program were dilutive for the three month period ended March 31, 2011, as the exercise price of $5.78 was less than the average market price of common shares. These warrants were not outstanding in the first quarter of 2012 as they were redeemed in August 2011.

Non-vested restricted stock grants totaling 61,615 average shares of common stock were dilutive for the first quarter ended March 31, 2012, as the fair value of the grant was less than the average market price of the common shares. There were no non-vested restricted stock shares outstanding during the first quarter of 2011.

NOTE 10   SUBSEQUENT EVENTS

On May 3, 2012, Oak Valley Bancorp repurchased from the U.S. Treasury 6,750 shares of Non-Cumulative Perpetual Preferred Stock, Series B, for aggregate consideration of $6.75 million in cash. The shares had been issued to the U.S. Treasury in September 2011 in connection with Oak Valley Bancorp s participation in the U.S. Treasury Small Business Lending Fund Program.

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear or that are referenced to elsewhere in this report, and with the audited consolidated financial statements and accompanying notes included in our 2011 Annual Report on Form 10-K, as amended. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions. This discussion and analysis includes executive management s (Management) insight of the Company s financial condition and results of operations of Oak Valley Bancorp and its subsidiary. Unless otherwise stated, the Company refers to the consolidated entity, Oak Valley Bancorp, while the Bank refers to Oak Valley Community Bank

Forward-Looking Statements

Some matters discussed in this Form 10-Q may be forward-looking statements within the meaning of the Private Litigation Reform Act of 1995 and therefore may involve risks, uncertainties and other factors which may cause our actual results to be materially different from the results expressed or implied by our forward-looking statements. These statements generally appear with words such as anticipate, believe, estimate, may, intend, and expect. Although management believes that the assumptions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions (both *generally and in the markets where the Company operates); competition from other providers of financial services offered by the Company; changes in government regulation and legislation; changes in interest rates; material unforeseen changes in the financial stability and liquidity of the Company s credit customers; risks associated with concentrations in real estate related loans; changes in accounting standards and interpretations; and other risks as may be detailed from time to time in the Company s filings with the Securities and Exchange Commission, all of which are difficult to predict and which may be beyond the control of the Company or the Company. The Company undertakes no obligation to revise forward-looking statements to reflect events or changes after the date of this discussion or to reflect the occurrence of unanticipated events.*

Forward-looking statements speak only as of the date they are made, and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made, whether as a result of new information, future developments or otherwise, except as may be required by law.

Critical Accounting Estimates

Management has determined the following five accounting policies to be critical:

Asset Impairment Judgments

Certain of our assets are carried in our statements of financial condition at fair value or at the lower of cost or fair value. Valuation allowances are established when necessary to recognize impairment of such assets. We periodically perform analyses to test for impairment of various assets. In addition to our impairment analyses related to loans, another significant impairment analysis relates to other than temporary declines in the value of our securities.

Table of Contents

Our available for sale portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as accumulated other comprehensive income in shareholders equity. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value and whether such decline is other than temporary. If such decline is deemed other than temporary, we would adjust the carrying amount of the security by writing down the security to fair market value through a charge to current period income. The market values of our securities are significantly affected by changes in interest rates.

In general, as interest rates rise, the market value of fixed-rate securities will decrease; as interest rates fall, the market value of fixed-rate securities will increase. With significant changes in interest rates, we evaluate our intent and ability to hold the security for a sufficient time to recover the recorded principal balance. Estimated fair values for securities are based on published or securities dealers market values. Market volatility is unpredictable and may impact such values.

Allowance for Loan Losses

Accounting for allowance for loan losses involves significant judgment and assumptions by management and is based on historical data and management s view of the current economic environment. At least on a quarterly basis, our management reviews the methodology and adequacy of allowance for loan losses and reports its assessment to the Board of Directors for its review and approval.

We base our allowance for loan losses on an estimation of probable losses inherent in our loan portfolio. Our methodology for assessing loan loss allowances are intended to reduce the differences between estimated and actual losses and involves a detailed analysis of our loan portfolio in three phases:

• the specific review of individual loans,

• the segmenting and review of loan pools with similar characteristics and,

• our judgmental estimate based on various subjective factors.

The first phase of our methodology involves the specific review of individual loans to identify and measure impairment. We evaluate each loan by use of a risk rating system, except for homogeneous loans, such as automobile loans and home mortgages. Specific risk rated loans are deemed impaired if all amounts, including principal and interest, will likely not be collected in accordance with the contractual terms of the related loan agreement. Impairment for commercial and real estate loans is measured either based on the present value of the loan s expected future cash flows or, if collection on the loan is collateral dependent, the estimated fair value of the collateral, less selling and holding costs.

The second phase involves the segmenting of the remainder of the risk rated loan portfolio into groups or pools of loans, together with loans with similar characteristics, for evaluation. We determine the calculated loss ratio to each loan pool based on its historical net losses and benchmark it against the levels of other peer banks.

In the third phase, we consider relevant internal and external factors that may affect the collectability of loan portfolio and each group of loan pool. The factors considered are, but are not limited to:

• concentration of credits,

• nature and volume of the loan portfolio,

• delinquency trends,

• non-accrual loan trend,

• problem loan trend,

• loss and recovery trend,

• quality of loan review,

• lending and management staff,

• lending policies and procedures,

• economic and business conditions, and

• other external factors including regulatory review.

Table of Contents

Our management estimates the probable effect of such conditions based on our judgment, experience and known or anticipated trends. Such estimation may be reflected as an additional allowance to each group of loans, if necessary. Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management s estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management s evaluation of the inherent loss related to such condition is reflected in the unallocated allowance.

Central to our credit risk management and our assessment of appropriate loss allowance is our loan risk rating system. Under this system, the originating credit officer assigns borrowers an initial risk rating based on a thorough analysis of each borrower s financial capacity in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior line and credit administration personnel. Credits are monitored by line and credit administration personnel for deterioration in a borrower s financial condition which may impact the ability of the borrower to perform under the contract. Although management has allocated a portion of the allowance to specific loans, specific loan pools, and off-balance sheet credit exposures (which are reported separately as part of other liabilities), the adequacy of the allowance is considered in its entirety.

Non-Accrual Loan Policy

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on nonaccrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due.

Stock-Based Compensation

The Company recognizes in the statement of income the grant-date fair value of stock options and other equity-based forms of compensation issued to employees over the employees requisite service period (generally the vesting period). The Company uses the straight-line recognition of expenses for awards with graded vesting. The Company utilizes a binomial pricing model for all grants. Expected volatility is based on the historical volatility of the price of the Company s stock for the period equal to the contractual stock option term. The Company uses historical data to estimate option exercise and stock option forfeiture rates within the valuation model. The expected term of options granted for the binomial model is derived from applying a historical suboptimal exercise factor to the contractual term of the grant. For binomial pricing, the risk-free rate for periods is equal to the U.S. Treasury yield at the time of grant and commensurate with the contractual term of the grant.

Other Real Estate Owned

Other real estate owned, which represents real estate acquired through foreclosure, or deed in lieu of foreclosure in satisfaction of commercial and real estate loans, is carried at the lower of cost or estimated fair value less the estimated selling costs of the real estate. The fair value of the property is based upon a current appraisal. The difference between the fair value of the real estate collateral and the loan balance at the time of transfer is recorded as a loan charge off if fair value is lower. Subsequent to foreclosure, management periodically performs valuations and the

OREO property is carried at the lower of carrying value or fair value, less costs to sell. The determination of a property s estimated fair value incorporates (1) revenues projected to be realized from disposal of the property, (2) construction and renovation costs, (3) marketing and transaction costs, and (4) holding costs (e.g., property taxes, insurance and homeowners association dues). Any subsequent declines in the fair value of the OREO property after the date of transfer are recorded through a write-down of the asset. Any subsequent operating expenses or income, reduction in estimated fair values, and gains or losses on disposition of such properties are charged or credited to current operations.

Introduction

Oak Valley Community Bank commenced operations in May 1991. We are an insured bank under the Federal Deposit Insurance Act and are a member of the Federal Reserve. Since its formation, the Company has provided basic banking services to individuals and business enterprises in Oakdale, California and the surrounding areas. The focus of the Company is to offer a range of commercial banking services designed for both individuals and small to medium-sized businesses in the two main areas of service of the Company: the Central Valley and the Eastern Sierras.

The Company offers a complement of business checking and savings accounts for its business customers. The Company also offers commercial and real estate loans, as well as lines of credit. Real estate loans are generally of a short-term nature for both residential and commercial purposes. Longer-term real estate loans are generally made with adjustable interest rates and contain normal provisions for acceleration. In addition, the Company offers traditional residential mortgages through a third party.

The Company also offers other services for both individuals and businesses including online banking, remote deposit capture, merchant services, night depository, extended hours, traveler s checks, wire transfer of funds, note collection, and automated teller machines in a national network. The Company does not currently offer international banking or trust services although the Company may make such services available to the Company s customers through financial institutions with which the Company has correspondent banking relationships. The Company does not offer stock transfer services nor does it directly issue credit cards.

Table of Contents

Effective July 3, 2008, Oak Valley Community Bank became a subsidiary of Oak Valley Bancorp, a newly established bank holding company. Oak Valley Bancorp operates Oak Valley Community Bank as a community bank in the general commercial banking business, with our primary market encompassing the California Central Valley around Oakdale and Modesto, and the Eastern Sierras. As such, unless otherwise noted, all references are about Oak Valley Bancorp (the Company).

Overview of Results of Operations and Financial Condition

The purpose of this summary is to provide an overview of the items management focuses on when evaluating the condition of the Company and its success in implementing its business and shareholder value strategies. The Company s business strategy is to operate the Company as a well-capitalized, profitable and independent community oriented bank. The Company s shareholders value strategy has three major themes: (1) enhancing shareholders value; (2) making its retail banking franchise more valuable; and (3) efficiently utilizing its capital.

Management believes the following were important factors in the Company s performance during the three month period ended March 31, 2012:

- Thanks to our deep roots in the communities that we serve, our focus on customer care and our selectivity in lending, during the first three months of 2012, our performance has been better than most institutions of our size that compete in our market. Despite the stagnant economy affecting our primary market areas, we have been able to increase our core deposits to $507.3 million and have posted net income available to common shareholders of $0.17 per diluted share for the three month period ended March 31, 2012. While recently published economic data indicate that the current downturn may be easing, it is not clear when or at what speed the recession will end. To the extent that the recession continues, it will affect the market areas that we serve and our results accordingly.

- The Company recognized net income available to common shareholders of $1,292,000 for the three month period ended March 31, 2012, as compared to $955,000 for the same period in 2011. The Company recognized net income before preferred stock dividends and accretion of $1,461,000 for the first quarter ended March 31, 2012 as compared to $1,165,000 for the first quarter ended March 31, 2011. The factors contributing to these results will be discussed below.

- The Company recognized $169,000 in the quarter ended March 31, 2012 associated with the accrual for preferred stock dividends for the 13,500 shares of Series B Preferred Stock that the U.S. Treasury owns under the Small Business Lending Fund (SBLF). So long as such preferred stock remains outstanding under SBLF, it will pay quarterly cumulative dividends at a variable rate between 1% and 5% per year for the first 2.5 years depending on growth of our small business loan portfolio. If there is no loan growth after 2.5 years, the dividend rate could increase to 7% and if the preferred stock remains outstanding after 4.5 years, the rate increases to 9%, regardless of loan growth. In comparison, the first quarter of 2011 reflected the $169,000 for preferred stock dividends but also included preferred stock accretion of $41,000 as the original series A preferred stock were issued under the TARP program at a discount.

- The Company has taken significant steps to reduce the risk of loan losses. In the three month period ended March 31, 2012, the provision for loan loss was $300,000, which was a decrease of $300,000 compared to the same period in 2011. The decrease was mainly due to management s assessment of the appropriate level for the allowance for loan losses and a decrease in the level of non-accrual loans. The Company continues to monitor its loan portfolio with the objective of avoiding defaults or write-downs. Despite these actions, the possibility of additional losses cannot be eliminated, but the Board of Directors and all employees continue to work hard to make the best of these continuing challenging conditions.

- Net interest income increased $58,000 or 0.9% for the three month period ended March 31, 2012, compared to the same period in 2011. The increase for the quarter was primarily due to the increase in average earning assets of $28.7 million for the three month period ended March 31, 2012, as compared to the same period of 2011.

- Non-interest income increased by $160,000 or 23.8% for the first quarter ended March 31, 2012, as compared to the same period in 2011. The increase was primarily due to an operating recovery of $120,000 and gains in mortgage commissions as described below.

- Non-interest expense increased by $71,000 or 1.6% for the three month period ended March 31, 2012, as compared to the same period in 2011. The primary reason for the increase was an increase in salaries and benefits and occupancy associated with new branch openings in mid-2011, which was offset in part by the reduction in the write downs of OREO property values as described below.

- Total assets decreased $18.7 million or 3.0% from December 31, 2011. Total net loans decreased by $2.7 million or 0.7% and investment securities increased by $15.4 million or 17.2% from December 31, 2011 to March 31, 2012, while deposits decreased by $17.5 million or 3.3% for the same period.

Table of Contents

Income Summary

For the three month period ended March 31, 2012, the Company recorded net income available to common shareholders of $1,292,000, representing an increase of $337,000 as compared to the same period in 2011. Return on average assets (annualized) was 0.98% for the first quarter ended March 31, 2012, as compared with 0.85% for the same period in 2011. Annualized return on average common equity was 8.94% for the first quarter ended March 31, 2012, as compared to 7.48% for the same period of 2011.

Net income before provisions for income taxes and preferred stock dividends and accretion was up $447,000 for the first quarter ended March 31, 2012 from the comparable 2011 period. The income statement components of these variances are as follows:

Pre-Tax Income Variance Summary:

(In thousands)		**Effect on Pre-Tax Income Increase (Decrease) Three Months Ended March 31, 2012**
Change from 2011 to 2012 in:		
Net interest income	$	58
Provision for loan losses		300
Non-interest income		160
Non-interest expense		(71)
Change in income before income taxes	$	447

These variances will be explained in the discussion below.

Net Interest Income

Net interest income is the largest source of the Company s operating income. For the three month period ended March 31, 2012, net interest income was $6.26 million, which represented an increase of $58,000 or 0.9% for the first quarter ended March 31, 2012, from the comparable period in 2011.

The net interest margin (net interest income as a percentage of average interest earning assets) was 4.67% for the three month period ended March 31, 2012, a decrease of 25 basis points, as compared to the same period in 2011. The decrease in the net interest margin in the first three months of 2012 was primarily attributable to a change in the mix of earning assets with a higher portion in investment securities and interest earning deposits in bank balances, which had balance increases of $29.0 million and 22.0 million, respectively, compared to the first quarter of 2011. These balances had yields of 4.05% and 0.23%, respectively, in the first quarter of 2012, which was significantly less than the yield on gross loans and thus driving down the overall yield on earning assets.

The current low market interest rate environment has had a positive impact on net interest income in previous years because the Company s balance sheet is liability sensitive which typically results in our average cost of funds decreasing faster than the average yield on interest earning assets in a declining rate environment. In 2012, we have not recognized this benefit to the same degree, as deposit interest rates are at historic lows and have essentially reached a threshold in which they cannot reasonably be further reduced. However, the total cost of funds did decrease 17 basis points in the first quarter ended March 31, 2012, compared to 2011 due to a shift from high cost CDs and FHLB borrowed funds into demand deposit and money market accounts. In addition, average non-interest-bearing demand deposit balances increased by $23.6 million for the three month period ended March 31, 2012, as compared to the same period of 2011. Compared to cost of funds, the decrease in earning asset yield was more significant at 38 basis points for the three month period ended March 31, 2012, compared to the same period of 2011. The investment securities portfolio recognized the most significant decrease of 90 basis points for the first quarter of 2012 as compared to 2011, mainly because of the Company deploying cash into investment security purchases, which have historically low yields. The yield on loans has remained more stable, with a reduction of 22 basis points for the first quarter of 2012 as compared to 2011, partly as a result of the significant portion of our loans that are at their contractual rate floors.

Table of Contents

The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three month period ended March 31, 2012 and 2011:

Net Interest Analysis

	Three months ended March 31, 2012			Three months ended March 31, 2011		
(Dollars in thousands)	**Average Balance**	**Interest Income / Expense**	**Avg Rate/ Yield**	**Average Balance**	**Interest Income / Expense**	**Avg Rate/ Yield**
Assets:						
Earning assets:						
Gross loans (1) (2)	$ 392,203	$ 5,718	5.85%	$ 397,337	$ 5,944	6.07%
Investment securities (2)	91,203	920	4.05%	62,203	759	4.95%
Federal funds sold	9,329	5	0.21%	26,466	15	0.23%
Interest-earning deposits	52,574	30	0.23%	30,609	17	0.23%
Total interest-earning assets	545,309	6,673	4.91%	516,615	6,735	5.29%
Total noninterest earning assets	53,801			37,519		
Total Assets	599,110			554,134		
Liabilities and Shareholders Equity:						
Interest-bearing liabilities:						
Money market deposits	256,972	148	0.23%	232,790	211	0.37%
NOW deposits	65,614	27	0.17%	63,351	35	0.22%
Savings deposits	24,380	16	0.26%	18,380	19	0.42%
Time certificates of deposit $100,000 or more	36,241	83	0.92%	33,687	104	1.25%
Other time deposits	23,255	41	0.71%	36,332	71	0.79%
Other borrowings	1,879	5	1.07%	8,000	22	1.12%
Total interest-bearing liabilities	408,341	320	0.31%	392,540	462	0.48%
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	116,677			93,101		
Other liabilities	2,574			3,225		
Total noninterest-bearing liabilities	119,251			96,326		
Shareholders equity	71,518			65,268		
Total liabilities and shareholders equity	$					