

PLUMAS BANCORP  
Form 10-Q  
August 03, 2016

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark  
One)**

**QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2016**

**TRANSITION REPORT UNDER SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**COMMISSION FILE NUMBER: 000-49883**

**PLUMAS BANCORP**

(Exact Name of Registrant as Specified in Its Charter)

**California**  
(State or Other Jurisdiction of Incorporation or  
Organization)

**75-2987096**  
(I.R.S. Employer Identification No.)

**35 S. Lindan Avenue, Quincy, California**  
(Address of Principal Executive Offices)

**95971**  
(Zip Code)

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Registrant's Telephone Number, Including Area Code **(530) 283-7305**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated Filer Accelerated Filer  
Non-Accelerated Filer Smaller Reporting Company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of August 1, 2016.  
4,864,235 shares

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**PART I – FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PLUMAS BANCORP****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

(In thousands, except share data)

|   | <b>June 30,<br/>2016</b> | <b>December<br/>31,<br/>2015</b> |
|---|--------------------------|----------------------------------|
| <b>Assets</b>   |                          |                                  |
| Cash and cash equivalents   | \$40,965                 | \$ 68,195                        |
| Investment securities available for sale  | 99,426                   | 96,704                           |
| Loans, less allowance for loan losses of \$6,430 at June 30, 2016 and \$6,078 at December 31, 2015  | 426,679                  | 396,833                          |
| Real estate acquired through foreclosure  | 2,817                    | 1,756                            |
| Premises and equipment, net   | 12,097                   | 12,234                           |
| Bank owned life insurance   | 12,358                   | 12,187                           |
| Accrued interest receivable and other assets  | 9,700                    | 11,377                           |
| Total assets  | \$604,042                | \$ 599,286                       |
| <b>Liabilities and Shareholders' Equity</b>   |                          |                                  |
| Deposits:   |                          |                                  |
| Non-interest bearing  | \$210,262                | \$ 209,044                       |
| Interest bearing  | 324,372                  | 318,232                          |
| Total deposits  | 534,634                  | 527,276                          |
| Repurchase agreements   | 3,894                    | 7,671                            |
| Note payable  | 2,625                    | 4,875                            |
| Accrued interest payable and other liabilities  | 6,167                    | 6,658                            |
| Junior subordinated deferrable interest debentures  | 10,310                   | 10,310                           |
| Total liabilities   | 557,630                  | 556,790                          |
| Commitments and contingencies (Note 5)  |                          |                                  |
| Shareholders' equity:   |                          |                                  |
| Common stock, no par value; 22,500,000 shares authorized; issued and outstanding – 4,861,635 shares at June 30, 2016 and 4,835,432 at December 31, 2015 | 5,746                    | 6,475                            |
| Retained earnings   | 39,473                   | 36,063                           |

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|  |           |            |
|--|-----------|------------|
| Accumulated other comprehensive income (loss), net | 1,193     | (42 )      |
| Total shareholders' equity                         | 46,412    | 42,496     |
| Total liabilities and shareholders' equity         | \$604,042 | \$ 599,286 |

See notes to unaudited condensed consolidated financial statements.

**PLUMAS BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

(In thousands, except per share data)

|  | <b>For the Three<br/>Months<br/>Ended June<br/>30,</b> |             | <b>For the Six<br/>Months<br/>Ended June 30,</b> |             |
|--|--|-------------|--|-------------|
|  | <b>2016</b>  | <b>2015</b> | <b>2016</b>                                      | <b>2015</b> |
| <b>Interest Income:</b>  |  |             |  |             |
| Interest and fees on loans                                     | \$5,553  | \$5,148     | \$11,009   | \$10,090    |
| Interest on investment securities                              | 473  | 418         | 945  | 816         |
| Other  | 51   | 28          | 123  | 64          |
| Total interest income  | 6,077  | 5,594       | 12,077   | 10,970      |
| <b>Interest Expense:</b>                                       |  |             |  |             |
| Interest on deposits   | 130  | 125         | 262  | 249         |
| Interest on note payable                                       | 31   | 44          | 76   | 55          |
| Interest on subordinated debenture                             | -  | 32          | -  | 219         |
| Interest on junior subordinated deferrable interest debentures | 85   | 75          | 169  | 150         |
| Other  | 1  | 1           | 2  | 3           |
| Total interest expense   | 247  | 277         | 509  | 676         |
| Net interest income before provision for loan losses           | 5,830  | 5,317       | 11,568   | 10,294      |
| <b>Provision for Loan Losses</b>                               | 200  | 300         | 400  | 600         |
| Net interest income after provision for loan losses            | 5,630  | 5,017       | 11,168   | 9,694       |
| <b>Non-Interest Income:</b>                                    |  |             |  |             |
| Service charges  | 1,034  | 1,006       | 1,965  | 1,945       |
| Gain on sale of loans  | 559  | 317         | 892  | 974         |
| (Loss) gain on sale of investments                             | -  | -           | (32 )  | 30          |
| Other  | 462  | 499         | 882  | 918         |
| Total non-interest income                                      | 2,055  | 1,822       | 3,707  | 3,867       |
| <b>Non-Interest Expenses:</b>                                  |  |             |  |             |
| Salaries and employee benefits                                 | 2,558  | 2,426       | 5,166  | 5,144       |
| Occupancy and equipment  | 677  | 680         | 1,384  | 1,380       |
| Other  | 1,445  | 1,523       | 2,763  | 2,811       |
| Total non-interest expenses                                    | 4,680  | 4,629       | 9,313  | 9,335       |
| Income before provision for income taxes                       | 3,005  | 2,210       | 5,562  | 4,226       |
| <b>Provision for Income Taxes</b>                              | 1,168  | 855         | 2,152  | 1,656       |
| Net income   | \$1,837  | \$1,355     | \$3,410  | \$2,570     |
| Basic earnings per share                                       | \$0.38   | \$0.28      | \$0.70   | \$0.53      |
| Diluted earnings per share                                     | \$0.36   | \$0.27      | \$0.67   | \$0.51      |

See notes to unaudited condensed consolidated financial statements.

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**PLUMAS BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

(In thousands)

|  | <b>For the Three<br/>Months<br/>Ended June 30,<br/>2016</b> |         | <b>For the Six<br/>Months<br/>Ended June 30,<br/>2015</b> |         |
|--|---|---------|---|---------|
| Net income   | \$1,837   | \$1,355 | \$3,410   | \$2,570 |
| Other comprehensive income (loss) :  |   |         |   |         |
| Change in net unrealized gain  | 681   | (832 )  | 2,072   | (179 )  |
| Less: reclassification adjustments for net losses (gains) included in net income | -   | -       | 32  | (30 )   |
| Net unrealized holding gains (losses)  | 681   | (832 )  | 2,104   | (209 )  |
| Related tax effect:  |   |         |   |         |
| Change in net unrealized gain  | (281 )  | 343     | (856 )  | 74      |
| Reclassification of net (losses) gains included in net income                    | -   | -       | (13 )   | 12      |
| Income tax effect  | (281 )  | 343     | (869 )  | 86      |
| Other comprehensive (loss) income  | 400   | (489 )  | 1,235   | (123 )  |
| Total comprehensive income   | \$2,237   | \$866   | \$4,645   | \$2,447 |

See notes to unaudited condensed consolidated financial statements.

**PLUMAS BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

(In thousands)

|  | <b>For the Six Months<br/>Ended June 30,</b> |             |
|--|--|-------------|
|  | <b>2016</b>                                  | <b>2015</b> |
| <b>Cash Flows from Operating Activities:</b>   |  |             |
| Net income   | \$3,410                                      | \$2,570     |
| Adjustments to reconcile net income to net cash provided by operating activities:                          |  |             |
| Provision for loan losses  | 400  | 600         |
| Change in deferred loan origination costs/fees, net  | (78 )  | (279 )      |
| Depreciation and amortization  | 538  | 618         |
| Stock-based compensation expense   | 55   | 41          |
| Loss (gain) on sale of Investments   | 32   | (30 )       |
| Amortization of investment security premiums   | 320  | 248         |
| Gain on sale of OREO and other vehicles  | (6 )   | (42 )       |
| Gain on sale of loans held for sale  | (892 )                                       | (974 )      |
| Loans originated for sale  | (14,863)                                     | (16,530)    |
| Proceeds from loan sales   | 15,307                                       | 13,971      |
| Provision from change in OREO valuation  | 9  | 43          |
| Earnings on bank-owned life insurance  | (171 )                                       | (170 )      |
| Decrease (increase) in accrued interest receivable and other assets  | 997  | (290 )      |
| Decrease in accrued interest payable and other liabilities   | (491 )                                       | (111 )      |
| Net cash provided by (used in) operating activities  | 4,567  | (335 )      |
| <b>Cash Flows from Investing Activities:</b>   |  |             |
| Proceeds from principal repayments from available-for-sale government-sponsored mortgage-backed securities | 5,973  | 5,780       |
| Proceeds from matured and called available-for-sale investment securities                                  | 1,000  | 1,000       |
| Purchases of available-for-sale securities   | (22,529)                                     | (13,994)    |
| Proceeds from sale of available-for-sale securities  | 14,589                                       | 6,669       |
| Net increase in loans  | (31,269)                                     | (19,427)    |
| Proceeds from sale of OREO   | 92   | 834         |
| Proceeds from sale of other vehicles   | 164  | 128         |
| Purchase of premises and equipment   | (375 )                                       | (1,202 )    |
| Net cash used in investing activities  | (32,355)                                     | (20,212)    |

Continued on next page.





**PLUMAS BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

(In thousands)

(Continued)

|   | <b>For the Six<br/>Months<br/>Ended June 30,<br/>2016      2015</b> |                 |
|---|---|-----------------|
| <b>Cash Flows from Financing Activities:</b>                          |   |                 |
| Net increase in demand, interest bearing and savings deposits         | \$8,520   | \$28,915        |
| Net decrease in time deposits   | (1,162 )  | (3,438 )        |
| Redemption of subordinated debenture                                  | -   | (7,500 )        |
| Borrowing on note payable   | -   | 4,000           |
| Principal payment on note payable                                     | (2,250 )  | -               |
| Net decrease in securities sold under agreements to repurchase        | (3,777 )  | (5,711 )        |
| Repurchase of common stock warrant                                    | (862 )  | -               |
| Proceeds from exercise of stock options                               | 89  | 40              |
| Net cash provided by financing activities                             | 558   | 16,306          |
| Decrease in cash and cash equivalents                                 | (27,230)  | (4,241 )        |
| <b>Cash and Cash Equivalents at Beginning of Year</b>                 | <b>68,195</b>   | <b>45,574</b>   |
| <b>Cash and Cash Equivalents at End of Period</b>                     | <b>\$40,965</b>   | <b>\$41,333</b> |
| <b>Supplemental Disclosure of Cash Flow Information:</b>              |   |                 |
| Cash paid during the period for:                                      |   |                 |
| Interest expense  | \$509   | \$596           |
| Income taxes  | \$2,500   | \$2,295         |
| <b>Non-Cash Investing Activities:</b>                                 |   |                 |
| Real estate and vehicles acquired through foreclosure                 | \$1,301   | \$412           |
| <b>Non-Cash Financing Activities:</b>                                 |   |                 |
| Common stock retired in connection with the exercise of stock options | \$-   | \$32            |

See notes to unaudited condensed consolidated financial statements.



**PLUMAS BANCORP**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. GENERAL**

During 2002, Plumas Bancorp (the "Company") was incorporated as a bank holding company for the purpose of acquiring Plumas Bank (the "Bank") in a one bank holding company reorganization. This corporate structure gives the Company and the Bank greater flexibility in terms of operation, expansion and diversification. The Company formed Plumas Statutory Trust I ("Trust I") for the sole purpose of issuing trust preferred securities on September 26, 2002. The Company formed Plumas Statutory Trust II ("Trust II") for the sole purpose of issuing trust preferred securities on September 28, 2005.

The Bank operates eleven branches in California, including branches in Alturas, Chester, Fall River Mills, Greenville, Kings Beach, Portola, Quincy, Redding, Susanville, Tahoe City, and Truckee. In December, 2015 the Bank opened a Branch in Reno, Nevada; it's first Branch outside of California. The Bank's administrative headquarters is in Quincy, California. In addition, the Bank operates lending offices specializing in government-guaranteed lending in Auburn, California, Scottsdale, Arizona and Seattle, Washington and commercial/agricultural lending offices in Chico, California and Klamath Falls, Oregon. The Bank's primary source of revenue is generated from providing loans to customers who are predominately small and middle market businesses and individuals residing in the surrounding areas.

**2. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The condensed consolidated financial statements include the accounts of the Company and the accounts of its wholly-owned subsidiary, Plumas Bank. Plumas Statutory Trust I and Plumas Statutory Trust II are not consolidated into the Company's consolidated financial statements and, accordingly, are accounted for under the equity method. In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the Company's financial position at June 30, 2016 and the results of its operations and its cash flows for the three-month and six-month periods ended June 30, 2016 and 2015. Our condensed consolidated balance sheet at December 31, 2015 is derived from audited financial statements. Certain reclassifications have been made to prior period's balances to conform to classifications used in 2016.

The unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted. The Company believes that the disclosures are adequate to make the information not misleading.

These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2015 Annual Report to Shareholders on Form 10-K. The results of operations for the three-month and six-month periods ended June 30, 2016 may not necessarily be indicative of future operating results. In preparing such financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the periods reported. Actual results could differ significantly from those estimates.

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

**3. INVESTMENT SECURITIES AVAILABLE FOR SALE**

The amortized cost and estimated fair value of investment securities at June 30, 2016 and December 31, 2015 consisted of the following, in thousands:

| <u>Available-for-Sale</u>  | June 30, 2016     |                              |                               |                            |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Debt securities:   |                   |                              |                               |                            |
| U.S. Government-sponsored agencies   | \$2,997           | \$ 6                         | \$ -                          | \$ 3,003                   |
| U.S. Government-sponsored agencies collateralized by mortgage obligations- residential | 70,248            | 918                          | (18 )                         | 71,148                     |
| Obligations of states and political subdivisions                                       | 24,150            | 1,125                        | -                             | 25,275                     |
|  | \$97,395          | \$ 2,049                     | \$ (18 )                      | \$ 99,426                  |

Net unrealized gain on available-for-sale investment securities totaling \$2,031,000 were recorded, net of \$838,000 in tax expense, as accumulated other comprehensive income within shareholders' equity at June 30, 2016. During the six months ended June 30, 2016 the Company sold fourteen available-for-sale investment securities for total proceeds of \$14,589,000 recording a \$32,000 loss on sale. The Company realized a gain on sale from eight of these securities totaling \$48,000 and a loss on sale on six securities of \$80,000. No securities were sold during the three months ended June 30, 2016.

| <u>Available-for-Sale</u>  | December 31, 2015 |                              |                               |                            |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Debt securities:   |                   |                              |                               |                            |
| U.S. Government-sponsored agencies   | \$1,994           | \$ -                         | \$ (17 )                      | \$ 1,977                   |
| U.S. Government-sponsored agencies collateralized by mortgage obligations- residential | 72,965            | 56                           | (651 )                        | 72,370                     |
| Obligations of states and political subdivisions                                       | 21,817            | 548                          | (8 )                          | 22,357                     |
|  | \$96,776          | \$ 604                       | \$ (676 )                     | \$ 96,704                  |

Net unrealized loss on available-for-sale investment securities totaling \$72,000 were recorded, net of \$30,000 in tax benefits, as accumulated other comprehensive income within shareholders' equity at December 31, 2015. During the

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six months ended June 30, 2015 the Company sold eight available-for-sale investment securities for total proceeds of \$6,669,000 recording a \$30,000 gain on sale. The Company realized a gain on sale from five of these securities totaling \$37,000 and a loss on sale on three securities of \$7,000. No securities were sold during the three months ended June 30, 2015.

There were no transfers of available-for-sale investment securities during the six months ended June 30, 2016 and twelve months ended December 31, 2015. There were no securities classified as held-to-maturity at June 30, 2016 or December 31, 2015.

Investment securities with unrealized losses at June 30, 2016 and December 31, 2015 are summarized and classified according to the duration of the loss period as follows, in thousands:

| <u>June 30, 2016</u>  | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Debt securities:  |                     |                   |                   |                   |            |                   |
| U.S. Government-sponsored agencies  | \$ -                | \$ -              | \$ -              | \$ -              | \$ -       | \$ -              |
| U.S. Government agencies collateralized by mortgage obligations-residential | -                   | -                 | 2,377             | \$ 18             | 2,377      | 18                |
| Obligations of states and political subdivisions                            | -                   | -                 | -                 | -                 | -          | -                 |
|   | \$ -                | \$ -              | \$ 2,377          | \$ 18             | \$ 2,377   | \$ 18             |

| <u>December 31, 2015</u>  | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Debt securities:  |                     |                   |                   |                   |            |                   |
| U.S. Government-sponsored agencies  | \$ 1,977            | \$ 17             | \$ -              | \$ -              | \$ 1,977   | \$ 17             |
| U.S. Government agencies collateralized by mortgage obligations-residential | 45,398              | 327               | 11,880            | 324               | 57,278     | 651               |
| Obligations of states and political subdivisions                            | 1,037               | 7                 | 160               | 1                 | 1,197      | 8                 |
|   | \$ 48,412           | \$ 351            | \$ 12,040         | \$ 325            | \$ 60,452  | \$ 676            |

At June 30, 2016, the Company held 155 securities of which 4 were in a loss position. Of the 155 securities 3 are U.S. Government-sponsored agencies 60 are U.S. Government-sponsored agencies collateralized by residential mortgage obligations and 92 were obligations of states and political subdivisions. The unrealized losses relate principally to market rate conditions. All of the securities continue to pay as scheduled. When analyzing an issuer's financial condition, management considers the length of time and extent to which the market value has been less than cost; the historical and implied volatility of the security; the financial condition of the issuer of the security; and the Company's intent and ability to hold the security to recovery. As of June 30, 2016, management does not have the intent to sell these securities nor does it believe it is more likely than not that it will be required to sell these securities before the recovery of its amortized cost basis. Based on the Company's evaluation of the above and other relevant factors, the Company does not believe the securities that are in an unrealized loss position as of June 30, 2016 are other than temporarily impaired.

The amortized cost and estimated fair value of investment securities at June 30, 2016 by contractual maturity are shown below, in thousands.



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|  | Amortized | Estimated  |
|--|-----------|------------|
|  | Cost      | Fair Value |
| Within one year  | \$ -      | \$ -       |
| After one year through five years                        | 1,603     | 1,621      |
| After five years through ten years                       | 17,872    | 18,641     |
| After ten years  | 7,672     | 8,016      |
| Investment securities not due at a single maturity date: |           |            |
| Government-sponsored mortgage-backed securities          | 70,248    | 71,148     |
|  | \$ 97,395 | \$ 99,426  |

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

Investment securities with amortized costs totaling \$57,948,000 and \$62,914,000 and estimated fair values totaling \$58,770,000 and \$62,483,000 June 30, 2016 and December 31, 2015, respectively, were pledged to secure deposits and repurchase agreements.

#### 4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES

Outstanding loans are summarized below, in thousands:

|   | June 30,<br>2016 | December<br>31,<br>2015 |
|---|------------------|-------------------------|
| Commercial                                      | \$41,083         | \$37,084                |
| Agricultural                                    | 47,069           | 39,856                  |
| Real estate – residential                       | 23,972           | 25,474                  |
| Real estate – commercial                        | 204,477          | 192,095                 |
| Real estate – construction and land development | 18,635           | 16,188                  |
| Equity lines of credit                          | 41,088           | 38,327                  |
| Auto  | 51,386           | 48,365                  |
| Other   | 3,574            | 3,582                   |
|   | 431,284          | 400,971                 |
| Deferred loan costs, net                        | 1,825            | 1,940                   |
| Allowance for loan losses                       | (6,430 )         | (6,078 )                |
|   | \$426,679        | \$396,833               |

Changes in the allowance for loan losses, in thousands, were as follows:

|                            | June<br>30,<br>2016 | December<br>31,<br>2015 |
|----------------------------|---------------------|-------------------------|
| Balance, beginning of year | \$6,078             | \$ 5,451                |

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|                                 |         |          |
|---------------------------------|---------|----------|
| Provision charged to operations | 400     | 1,100    |
| Losses charged to allowance     | (530 )  | (827 )   |
| Recoveries                      | 482     | 354      |
| Balance, end of year            | \$6,430 | \$ 6,078 |

The recorded investment in impaired loans totaled \$5,716,000 and \$6,461,000 at June 30, 2016 and December 31, 2015, respectively. The Company had specific allowances for loan losses of \$542,000 on impaired loans of \$1,778,000 at June 30, 2016 as compared to specific allowances for loan losses of \$751,000 on impaired loans of \$2,346,000 at December 31, 2015. The balance of impaired loans in which no specific reserves were required totaled \$3,938,000 and \$4,115,000 at June 30, 2016 and December 31, 2015, respectively. The average recorded investment in impaired loans for the six months ended June 30, 2016 and June 30, 2015 was \$5,421,000 and \$7,096,000, respectively. The Company recognized \$61,000 and \$60,000 in interest income for impaired loans during the six months ended June 30, 2016 and 2015, respectively. No interest was recognized on nonaccrual loans accounted for on a cash basis during the six months ended June 30, 2016 and 2015.

Included in impaired loans are troubled debt restructurings. A troubled debt restructuring is a formal restructure of a loan where the Company for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower. The concessions may be granted in various forms to include one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

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.

The carrying value of troubled debt restructurings at June 30, 2016 and December 31, 2015 was \$4,873,000 and \$4,661,000, respectively. The Company has allocated \$388,000 and \$311,000 of specific reserves on loans to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2016 and December 31, 2015, respectively. The Company has not committed to lend additional amounts on loans classified as troubled debt restructurings at June 30, 2016 and December 31, 2015.

There were no troubled debt restructurings that occurred during the six months ending June 30, 2016 or June 30, 2015.

There were no troubled debt restructurings for which there was a payment default within twelve months following the modification during the six months ended June 30, 2016 and 2015, respectively.

At June 30, 2016 and December 31, 2015, nonaccrual loans totaled \$2,968,000 and \$4,546,000, respectively. Interest foregone on nonaccrual loans totaled \$106,000 and \$220,000 for the six months ended June 30, 2016 and 2015, respectively. Interest foregone on nonaccrual loans totaled \$31,000 and \$102,000 for the three months ended June 30, 2016 and 2015, respectively. There were no loans past due 90 days or more and on accrual status at June 30, 2016 and December 31, 2015.

Salaries and employee benefits totaling \$942,000 and \$716,000 have been deferred as loan origination costs during the six months ended June 30, 2016 and 2015, respectively. Salaries and employee benefits totaling \$569,000 and \$399,000 have been deferred as loan origination costs during the three months ended June 30, 2016 and 2015, respectively.

The balance of other real estate includes \$0 and \$84 thousand of foreclosed residential real estate properties recorded as a result of obtaining physical possession of the property as of June 30, 2016 and December 31, 2015, respectively. The recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceeds are in process was \$65 thousand and \$23 thousand as of June 30, 2016 and December 31, 2015, respectively.

The Company assigns a risk rating to all loans, with the exception of automobile and other loans and periodically, but not less than annually, performs detailed reviews of all such loans over \$100,000 to identify credit risks and to assess

the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Company and the Company's regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan.

The risk ratings can be grouped into five major categories, defined as follows:

**Pass** – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

**Watch** – A Watch loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Company's credit position at some future date. Watch loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

**Substandard** – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful** – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

**Loss** – Loans classified as loss are considered uncollectible and charged off immediately.

The following table shows the loan portfolio allocated by management's internal risk ratings at the dates indicated, in thousands:

**June 30, 2016 Commercial Credit Exposure**

**Credit Risk Profile by Internally Assigned Grade**

| Grade:      | Commercial | Agricultural | Real        | Real       | Real         | Equity   | Total     |
|-------------|------------|--------------|-------------|------------|--------------|----------|-----------|
|             |            |              | Estate-     | Estate-    | Estate-      | LOC      |           |
|             |            |              | Residential | Commercial | Construction |          |           |
| Pass        | \$39,350   | \$ 46,744    | \$ 23,473   | \$ 200,199 | \$ 17,552    | \$40,856 | \$368,174 |
| Watch       | 1,155      | 279          | 401         | 2,254      | 243          | -        | 4,332     |
| Substandard | 578        | 46           | 98          | 2,024      | 840          | 232      | 3,818     |
| Doubtful    | -          | -            | -           | -          | -            | -        | -         |
| Total       | \$41,083   | \$ 47,069    | \$ 23,972   | \$ 204,477 | \$ 18,635    | \$41,088 | \$376,324 |

**December 31, 2015 Commercial Credit Exposure**

**Credit Risk Profile by Internally Assigned Grade**

| Grade:      | Commercial | Agricultural | Real        | Real       | Real         | Equity   | Total     |
|-------------|------------|--------------|-------------|------------|--------------|----------|-----------|
|             |            |              | Estate-     | Estate-    | Estate-      | LOC      |           |
|             |            |              | Residential | Commercial | Construction |          |           |
| Pass        | \$35,508   | \$ 39,426    | \$ 25,220   | \$ 185,739 | \$ 15,048    | \$37,983 | \$338,924 |
| Watch       | 883        | 387          | 149         | 2,442      | 247          | -        | 4,108     |
| Substandard | 693        | 43           | 105         | 3,914      | 893          | 344      | 5,992     |
| Doubtful    | -          | -            | -           | -          | -            | -        | -         |
| Total       | \$37,084   | \$ 39,856    | \$ 25,474   | \$ 192,095 | \$ 16,188    | \$38,327 | \$349,024 |

**Consumer Credit  
Exposure**

**Credit Risk Profile**

**Based on Payment  
Activity**

**Consumer Credit  
Exposure**

**Credit Risk Profile**

**Based on Payment  
Activity**

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|                | June 30, 2016 |         |          | December 31, 2015 |         |          |
|----------------|---------------|---------|----------|-------------------|---------|----------|
|                | Auto          | Other   | Total    | Auto              | Other   | Total    |
| Grade:         |               |         |          |                   |         |          |
| Performing     | \$51,306      | \$3,542 | \$54,848 | \$48,300          | \$3,582 | \$51,882 |
| Non-performing | 80            | 32      | 112      | 65                | -       | 65       |
| Total          | \$51,386      | \$3,574 | \$54,960 | \$48,365          | \$3,582 | \$51,947 |

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The following tables show the allocation of the allowance for loan losses at the dates indicated, in thousands:

|                                    | Commercial | Agricultural | Estate-<br>Residential | Estate-<br>Commercial | Estate-<br>Construction | Equity<br>LOC | Auto   | Other | Total    |
|------------------------------------|------------|--------------|------------------------|-----------------------|-------------------------|---------------|--------|-------|----------|
| <b>Six months ended 6/30/16:</b>   |            |              |                        |                       |                         |               |        |       |          |
| <u>Allowance for Loan Losses</u>   |            |              |                        |                       |                         |               |        |       |          |
| Beginning balance                  | \$ 639     | \$ 294       | \$ 341                 | \$ 2,525              | \$ 874                  | \$ 528        | \$ 784 | \$ 93 | \$ 6,078 |
| Charge-offs                        | (73 )      | -            | -                      | (252 )                | -                       | (23 )         | (158 ) | (24 ) | (530 )   |
| Recoveries                         | 17         | -            | 36                     | 2                     | 329                     | 1             | 82     | 15    | 482      |
| Provision                          | 252        | 122          | (55 )                  | 190                   | (320 )                  | 67            | 133    | 11    | 400      |
| Ending balance                     | \$ 835     | \$ 416       | \$ 322                 | \$ 2,465              | \$ 883                  | \$ 573        | \$ 841 | \$ 95 | \$ 6,430 |
| <b>Three months ended 6/30/16:</b> |            |              |                        |                       |                         |               |        |       |          |
| <u>Allowance for Loan Losses</u>   |            |              |                        |                       |                         |               |        |       |          |
| Beginning balance                  | \$ 637     | \$ 311       | \$ 318                 | \$ 2,762              | \$ 800                  | \$ 524        | \$ 763 | \$ 83 | \$ 6,198 |
| Charge-offs                        | -          | -            | -                      | (252 )                | -                       | 1             | (53 )  | (6 )  | (310 )   |
| Recoveries                         | 6          | -            | 1                      | 2                     | 300                     | 1             | 25     | 7     | 342      |
| Provision                          | 192        | 105          | 3                      | (47 )                 | (217 )                  | 47            | 106    | 11    | 200      |
| Ending balance                     | \$ 835     | \$ 416       | \$ 322                 | \$ 2,465              | \$ 883                  | \$ 573        | \$ 841 | \$ 95 | \$ 6,430 |
| <b>Six months ended 6/30/15:</b>   |            |              |                        |                       |                         |               |        |       |          |
| <u>Allowance for Loan Losses</u>   |            |              |                        |                       |                         |               |        |       |          |
| Beginning balance                  | \$ 574     | \$ 225       | \$ 379                 | \$ 1,701              | \$ 1,227                | \$ 691        | \$ 581 | \$ 73 | \$ 5,451 |
| Charge-offs                        | (54 )      | (3 )         | (53 )                  | -                     | (55 )                   | (59 )         | (204 ) | (22 ) | (450 )   |
| Recoveries                         | 90         | -            | 4                      | -                     | -                       | 3             | 55     | 27    | 179      |
| Provision                          | 18         | 20           | 69                     | 439                   | (141 )                  | (101 )        | 285    | 11    | 600      |
| Ending balance                     | \$ 628     | \$ 242       | \$ 399                 | \$ 2,140              | \$ 1,031                | \$ 534        | \$ 717 | \$ 89 | \$ 5,780 |
| <b>Three months ended 6/30/15:</b> |            |              |                        |                       |                         |               |        |       |          |
| <u>Allowance for Loan Losses</u>   |            |              |                        |                       |                         |               |        |       |          |
| Beginning balance                  | \$ 582     | \$ 222       | \$ 419                 | \$ 1,963              | \$ 1,228                | \$ 587        | \$ 627 | \$ 94 | \$ 5,722 |
| Charge-offs                        | (14 )      | (3 )         | (48 )                  | -                     | (54 )                   | (51 )         | (93 )  | (12 ) | (275 )   |
| Recoveries                         | 9          | -            | 2                      | -                     | -                       | 1             | 12     | 9     | 33       |
| Provision                          | 51         | 23           | 26                     | 177                   | (143 )                  | (3 )          | 171    | (2 )  | 300      |
| Ending balance                     | \$ 628     | \$ 242       | \$ 399                 | \$ 2,140              | \$ 1,031                | \$ 534        | \$ 717 | \$ 89 | \$ 5,780 |
| <b>June 30, 2016:</b>              |            |              |                        |                       |                         |               |        |       |          |



Allowance for  
Loan Losses

Ending balance:

|   |        |      |       |       |        |       |     |     |       |
|---|--------|------|-------|-------|--------|-------|-----|-----|-------|
| individually<br>evaluated for<br>impairment | \$ 124 | \$ 3 | \$ 54 | \$ 81 | \$ 253 | \$ 27 | \$- | \$- | \$542 |
|---|--------|------|-------|-------|--------|-------|-----|-----|-------|

Ending balance:

|   |        |        |        |          |        |        |        |       |         |
|---|--------|--------|--------|----------|--------|--------|--------|-------|---------|
| collectively<br>evaluated for<br>impairment | \$ 711 | \$ 413 | \$ 268 | \$ 2,384 | \$ 630 | \$ 546 | \$ 841 | \$ 95 | \$5,888 |
|---|--------|--------|--------|----------|--------|--------|--------|-------|---------|

Loans

|                |           |           |           |            |           |           |           |          |            |
|----------------|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|
| Ending balance | \$ 41,083 | \$ 47,069 | \$ 23,972 | \$ 204,477 | \$ 18,635 | \$ 41,088 | \$ 51,386 | \$ 3,574 | \$ 431,284 |
|----------------|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|

Ending balance:

|   |        |        |          |          |        |        |       |       |          |
|---|--------|--------|----------|----------|--------|--------|-------|-------|----------|
| individually<br>evaluated for<br>impairment | \$ 143 | \$ 261 | \$ 1,570 | \$ 2,456 | \$ 973 | \$ 202 | \$ 80 | \$ 31 | \$ 5,716 |
|---|--------|--------|----------|----------|--------|--------|-------|-------|----------|

Ending balance:

|   |           |           |           |            |           |           |           |          |            |
|---|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|
| collectively<br>evaluated for<br>impairment | \$ 40,940 | \$ 46,808 | \$ 22,402 | \$ 202,021 | \$ 17,662 | \$ 40,886 | \$ 51,306 | \$ 3,543 | \$ 425,568 |
|---|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|

**December 31,****2015:**Allowance for  
Loan Losses

Ending balance:

|   |       |      |       |        |        |       |     |     |       |
|---|-------|------|-------|--------|--------|-------|-----|-----|-------|
| individually<br>evaluated for<br>impairment | \$ 26 | \$ - | \$ 54 | \$ 371 | \$ 269 | \$ 31 | \$- | \$- | \$751 |
|---|-------|------|-------|--------|--------|-------|-----|-----|-------|

Ending balance:

|   |        |        |        |          |        |        |        |       |          |
|---|--------|--------|--------|----------|--------|--------|--------|-------|----------|
| collectively<br>evaluated for<br>impairment | \$ 613 | \$ 294 | \$ 287 | \$ 2,154 | \$ 605 | \$ 497 | \$ 784 | \$ 93 | \$ 5,327 |
|---|--------|--------|--------|----------|--------|--------|--------|-------|----------|

Loans

|                |           |           |           |            |           |           |           |          |            |
|----------------|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|
| Ending balance | \$ 37,084 | \$ 39,856 | \$ 25,474 | \$ 192,095 | \$ 16,188 | \$ 38,327 | \$ 48,365 | \$ 3,582 | \$ 400,971 |
|----------------|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|

Ending balance:

|   |       |        |          |          |          |        |       |     |          |
|---|-------|--------|----------|----------|----------|--------|-------|-----|----------|
| individually<br>evaluated for<br>impairment | \$ 73 | \$ 260 | \$ 1,593 | \$ 3,129 | \$ 1,029 | \$ 311 | \$ 66 | \$- | \$ 6,461 |
|---|-------|--------|----------|----------|----------|--------|-------|-----|----------|

Ending balance:

|   |           |           |           |            |           |           |           |          |            |
|---|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|
| collectively<br>evaluated for<br>impairment | \$ 37,011 | \$ 39,596 | \$ 23,881 | \$ 188,966 | \$ 15,159 | \$ 38,016 | \$ 48,299 | \$ 3,582 | \$ 394,510 |
|---|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|------------|

The following table shows an aging analysis of the loan portfolio by the time past due, in thousands:

| <b>June 30, 2016</b>              | 30-89<br>Days<br>Past<br>Due | 90 Days     |                 | Total Past      |                  |                  |
|-----------------------------------|------------------------------|-------------|-----------------|-----------------|------------------|------------------|
|                                   |                              | and Still   |                 | Due and         |                  |                  |
|                                   |                              | Accruing    | Nonaccrual      | Nonaccrual      | Current          | Total            |
| Commercial                        | \$683                        | \$ -        | \$ 126          | \$ 809          | \$40,274         | \$41,083         |
| Agricultural                      | -                            | -           | 3               | 3               | 47,066           | 47,069           |
| Real estate – residential         | 145                          | -           | 83              | 228             | 23,744           | 23,972           |
| Real estate – construction & land | -                            | -           | 840             | 840             | 17,795           | 18,635           |
| Real estate – commercial          | 173                          | -           | 1,603           | 1,776           | 202,701          | 204,477          |
| Equity Lines of Credit            | 109                          | -           | 202             | 311             | 40,777           | 41,088           |
| Auto                              | 590                          | -           | 80              | 670             | 50,716           | 51,386           |
| Other                             | 22                           | -           | 31              | 53              | 3,521            | 3,574            |
| <b>Total</b>                      | <b>\$1,722</b>               | <b>\$ -</b> | <b>\$ 2,968</b> | <b>\$ 4,690</b> | <b>\$426,594</b> | <b>\$431,284</b> |

| <b>December 31, 2015</b>          | 30-89<br>Days<br>Past<br>Due | 90 Days     |                 | Total Past      |                  |                  |
|-----------------------------------|------------------------------|-------------|-----------------|-----------------|------------------|------------------|
|                                   |                              | and Still   |                 | Due and         |                  |                  |
|                                   |                              | Accruing    | Nonaccrual      | Nonaccrual      | Current          | Total            |
| Commercial                        | \$457                        | \$ -        | \$ 56           | \$ 513          | \$36,571         | \$37,084         |
| Agricultural                      | -                            | -           | -               | -               | 39,856           | 39,856           |
| Real estate – residential         | 472                          | -           | 90              | 562             | 24,912           | 25,474           |
| Real estate – commercial          | -                            | -           | 3,130           | 3,130           | 188,965          | 192,095          |
| Real estate – construction & land | 9                            | -           | 893             | 902             | 15,286           | 16,188           |
| Equity Lines of Credit            | 8                            | -           | 312             | 320             | 38,007           | 38,327           |
| Auto                              | 586                          | -           | 65              | 651             | 47,714           | 48,365           |
| Other                             | 15                           | -           | -               | 15              | 3,567            | 3,582            |
| <b>Total</b>                      | <b>\$1,547</b>               | <b>\$ -</b> | <b>\$ 4,546</b> | <b>\$ 6,093</b> | <b>\$394,878</b> | <b>\$400,971</b> |

The following tables show information related to impaired loans at the dates indicated, in thousands:

| <b><u>As of June 30, 2016:</u></b>  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 19                  | \$ 19                          |                      | \$ 19                             | \$ 1                             |
| Agricultural                        | 258                    | 258                            |                      | 259                               | 10                               |
| Real estate – residential           | 1,327                  | 1,338                          |                      | 1,336                             | 39                               |
| Real estate – commercial            | 1,922                  | 2,360                          |                      | 1,756                             | 2                                |
| Real estate – construction & land   | 209                    | 209                            |                      | 215                               | -                                |
| Equity Lines of Credit              | 92                     | 92                             |                      | 96                                | -                                |
| Auto                                | 80                     | 80                             |                      | 40                                | -                                |
| Other                               | 31                     | 31                             |                      | -                                 | -                                |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 124                 | \$ 124                         | \$ 124               | \$ 28                             | \$ -                             |
| Agricultural                        | 3                      | 3                              | 3                    | 6                                 | -                                |
| Real estate – residential           | 243                    | 243                            | 54                   | 244                               | 5                                |
| Real estate – commercial            | 534                    | 742                            | 81                   | 534                               | -                                |
| Real estate – construction & land   | 764                    | 764                            | 253                  | 776                               | 4                                |
| Equity Lines of Credit              | 110                    | 110                            | 27                   | 112                               | -                                |
| Auto                                | -                      | -                              | -                    | -                                 | -                                |
| Other                               | -                      | -                              | -                    | -                                 | -                                |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 143                 | \$ 143                         | \$ 124               | \$ 47                             | \$ 1                             |
| Agricultural                        | 261                    | 261                            | 3                    | 265                               | 10                               |
| Real estate – residential           | 1,570                  | 1,581                          | 54                   | 1,580                             | 44                               |
| Real estate – commercial            | 2,456                  | 3,102                          | 81                   | 2,290                             | 2                                |
| Real estate – construction & land   | 973                    | 973                            | 253                  | 991                               | 4                                |
| Equity Lines of Credit              | 202                    | 202                            | 27                   | 208                               | -                                |
| Auto                                | 80                     | 80                             | -                    | 40                                | -                                |
| Other                               | 31                     | 31                             | -                    | -                                 | -                                |
| Total                               | \$ 5,716               | \$ 6,373                       | \$ 542               | \$ 5,421                          | \$ 61                            |

| <b><u>As of December 31, 2015:</u></b> | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded:    |                        |                                |                      |                                   |                                  |
| Commercial                             | \$ 47                  | \$ 47                          |                      | \$ 39                             | \$ 1                             |
| Agricultural                           | 260                    | 260                            |                      | 262                               | 20                               |
| Real estate – residential              | 1,347                  | 1,359                          |                      | 1,346                             | 79                               |
| Real estate – commercial               | 1,976                  | 2,622                          |                      | 2,057                             | -                                |
| Real estate – construction & land      | 221                    | 221                            |                      | 232                               | -                                |
| Equity Lines of Credit                 | 199                    | 199                            |                      | 156                               | -                                |
| Auto                                   | 65                     | 65                             |                      | 21                                | -                                |
| Other                                  | -                      | -                              |                      | -                                 | -                                |
| With an allowance recorded:            |                        |                                |                      |                                   |                                  |
| Commercial                             | \$ 26                  | \$ 26                          | \$ 26                | \$ 29                             | \$ -                             |
| Agricultural                           | -                      | -                              | -                    | -                                 | -                                |
| Real estate – residential              | 245                    | 245                            | 54                   | 246                               | 11                               |
| Real estate – commercial               | 1,154                  | 1,154                          | 371                  | 1,203                             | -                                |
| Real estate – construction & land      | 808                    | 808                            | 269                  | 822                               | 8                                |
| Equity Lines of Credit                 | 113                    | 113                            | 31                   | 115                               | -                                |
| Auto                                   | -                      | -                              | -                    | -                                 | -                                |
| Other                                  | -                      | -                              | -                    | -                                 | -                                |
| Total:                                 |                        |                                |                      |                                   |                                  |
| Commercial                             | \$ 73                  | \$ 73                          | \$ 26                | \$ 68                             | \$ 1                             |
| Agricultural                           | 260                    | 260                            | -                    | 262                               | 20                               |
| Real estate – residential              | 1,592                  | 1,604                          | 54                   | 1,592                             | 90                               |
| Real estate – commercial               | 3,130                  | 3,776                          | 371                  | 3,260                             | -                                |
| Real estate – construction & land      | 1,029                  | 1,029                          | 269                  | 1,054                             | 8                                |
| Equity Lines of Credit                 | 312                    | 312                            | 31                   | 271                               | -                                |
| Auto                                   | 65                     | 65                             | -                    | 21                                | -                                |
| Other                                  | -                      | -                              | -                    | -                                 | -                                |
| Total                                  | \$ 6,461               | \$ 7,119                       | \$ 751               | \$ 6,528                          | \$ 119                           |

## 5. COMMITMENTS AND CONTINGENCIES

The Company is party to claims and legal proceedings arising in the ordinary course of business. In the opinion of the Company's management, the amount of ultimate liability with respect to such proceedings will not have a material adverse effect on the financial condition or result of operations of the Company taken as a whole.

In the normal course of business, there are various outstanding commitments to extend credit, which are not reflected in the financial statements, including loan commitments of \$87,925,000 and \$82,995,000 and stand-by letters of credit of \$625,000 and \$265,000 at June 30, 2016 and December 31, 2015, respectively.

Of the loan commitments outstanding at June 30, 2016, \$10,775,000 are real estate construction loan commitments that are expected to fund within the next twelve months. The remaining commitments primarily relate to revolving lines of credit or other commercial loans, and many of these are expected to expire without being drawn upon. Therefore, the total commitments do not necessarily represent future cash requirements. Each loan commitment and the amount and type of collateral obtained, if any, are evaluated on an individual basis. Collateral held varies, but may include real property, bank deposits, debt or equity securities or business assets.

Stand-by letters of credit are conditional commitments written to guarantee the performance of a customer to a third party. These guarantees are primarily related to the purchases of inventory by commercial customers and are typically short-term in nature. Credit risk is similar to that involved in extending loan commitments to customers and accordingly, evaluation and collateral requirements similar to those for loan commitments are used. The deferred liability related to the Company's stand-by letters of credit was not significant at June 30, 2016 or December 31, 2015.

## 6. EARNINGS PER SHARE

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which shares in the earnings of the Company. The treasury stock method has been applied to determine the dilutive effect of stock options in computing diluted earnings per share.

| <b>For the Three<br/>Months</b> | <b>For the Six<br/>Months</b> |
|---------------------------------|-------------------------------|
|---------------------------------|-------------------------------|

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|   | Ended June<br>30, |         | Ended June<br>30, |         |
|---|-------------------|---------|-------------------|---------|
|   | 2016              | 2015    | 2016              | 2015    |
| (In thousands, except per share data)                 |                   |         |                   |         |
| <b>Net Income:</b>                                    |                   |         |                   |         |
| Net income  | \$1,837           | \$1,355 | \$3,410           | \$2,570 |
| <b>Earnings Per Share:</b>                            |                   |         |                   |         |
| Basic earnings per share                              | \$0.38            | \$0.28  | \$0.70            | \$0.53  |
| Diluted earnings per share                            | \$0.36            | \$0.27  | \$0.67            | \$0.51  |
| <b>Weighted Average Number of Shares Outstanding:</b> |                   |         |                   |         |
| Basic shares  | 4,857             | 4,813   | 4,849             | 4,806   |
| Diluted shares  | 5,047             | 5,069   | 5,057             | 5,058   |

Shares of common stock issuable under stock options and warrants for which the exercise prices were greater than the average market prices were not included in the computation of diluted earnings per share due to their antidilutive effect. Stock options and warrants not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 113,000 and 53,000 for the three month periods ended June 30, 2016 and 2015, respectively. Stock options and warrants not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 113,000 and 53,000 for the six month periods ended June 30, 2016 and 2015, respectively.

## 7. STOCK-BASED COMPENSATION

### Stock Options

In 2001, the Company established a Stock Option Plan for which 120,133 shares of common stock remain reserved for issuance to employees and directors and no shares are available for future grants as of June 30, 2016.

As of June 30, 2016, all remaining shares in this plan have vested and no compensation cost remains unrecognized.

The total fair value of options vested was \$0 and \$49,000 for six months ended June 30, 2016 and 2015. The total intrinsic value of options at time of exercise was \$131,000 and \$163,000 for the six months ended June 30, 2016 and 2015, respectively.

Cash received from option exercises for the six months ended June 30, 2016 and 2015 were \$65,000 and \$44,000, respectively. There was no tax benefit realized for the tax deduction from options exercised during the six months ended June 30, 2016 and 2015.

A summary of the activity within the 2001 Stock Option Plan follows:

|  |               |         | <b>Weighted</b> |                    |                  |
|--|---------------|---------|-----------------|--------------------|------------------|
|  |               |         | <b>Weighted</b> | <b>Average</b>     |                  |
|  | <b>Shares</b> |         | <b>Average</b>  | <b>Remaining</b>   | <b>Intrinsic</b> |
|  |               |         | <b>Exercise</b> | <b>Contractual</b> | <b>Value</b>     |
|  |               |         | <b>Price</b>    | <b>Term in</b>     |                  |
|  |               |         |                 | <b>Years</b>       |                  |
| Options outstanding at January 1, 2016 | 192,893       | \$ 5.75 |                 |                    |                  |
| Options forfeited                      | (50,800 )     | 12.19   |                 |                    |                  |
| Options exercised                      | (21,960 )     | 2.95    |                 |                    |                  |
| Options outstanding at June 30, 2016   | 120,133       | \$ 3.53 |                 | 2.6                | \$ 698,000       |

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Options exercisable at June 30, 2016      120,133    \$ 3.53            2.6            \$698,000

In May 2013, the Company established the 2013 Stock Option Plan for which 491,443 shares of common stock are reserved and 288,800 shares are available for future grants as of June 30, 2016. The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised. Payment in full for the option price must be made in cash, with Company common stock previously acquired by the optionee and held by the optionee for a period of at least six months, in options of the Optionee that are fully vested and exercisable or in any combination of the foregoing. The options expire on dates determined by the Board of Directors, but not later than ten years from the date of grant.

During the six months ended June 30, 2016 the Company granted options to purchase 108,000 shares of common stock. The fair value of each option was estimated on the date of grant using the following assumptions.

|  |        |
|--|--------|
|  | 2016   |
| Expected life of stock options (in years)  | 5.1    |
| Risk free interest rate  | 1.52%  |
| Volatility   | 53.6%  |
| Dividend yields  | 2.00%  |
| Weighted-average fair value of options granted during the six months ended June 30, 2016 | \$3.55 |

No options were granted during the six months ended June 30, 2015.

As of June 30, 2016, there was \$343,000 of total unrecognized compensation cost related to non-vested, share-based compensation arrangements granted under the 2013 Plan. That cost is expected to be recognized over a weighted average period of 3.1 years.



The total fair value of options vested was \$76,000 and \$83,000 for six months ended June 30, 2016 and 2015. The total intrinsic value of options at time of exercise was \$14,000 and \$0 for the six months ended June 30, 2016 and 2015, respectively.

Cash received from option exercises for the six months ended June 30, 2016 and 2015 were \$23,000 and \$0, respectively. There was no tax benefit realized for the tax deduction from options exercised during the six months ended June 30, 2016 and 2015.

A summary of the activity within the 2013 Plan follows:

|  | Shares   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>in Years | Intrinsic<br>Value |
|--|----------|--|---|--------------------|
| Options outstanding at January 1, 2016 | 102,400  | \$ 6.32                                  |   |                    |
| Options granted                        | 108,000  | 8.75                                     |   |                    |
| Options exercised                      | (6,000 ) | 6.32                                     |   |                    |
| Options outstanding at June 30, 2016   | 204,400  | \$ 7.60                                  | 6.8   | \$288,000          |
| Options exercisable at June 30, 2016   | 46,000   | 6.32                                     | 5.8   | \$124,000          |
| Expected to vest after June 30, 2016   | 138,172  | \$ 7.98                                  | 7.1   | \$143,000          |

Compensation cost related to stock options recognized in operating results under the two stock option plans was \$55,000 and \$41,000 for the six months ended June 30, 2016 and 2015, respectively. The associated income tax benefit recognized was \$6,000 for the six months ended June 30, 2016 and \$4,000 for the six months ended June 30, 2015. Compensation cost related to stock options recognized in operating results under the two stock option plans was \$30,000 and \$12,000 for the three months ended June 30, 2016 and 2015, respectively. The associated income tax benefit recognized was \$3,000 for the three months ended June 30, 2016 and \$2,000 for the three months ended June 30, 2015.

The Company determines the fair value of options on the date of grant using a Black-Scholes-Merton option pricing model that uses assumptions based on expected option life, expected stock volatility and the risk-free interest rate. The expected volatility assumptions used by the Company are based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options. The Company bases its expected life assumption on its historical experience and on the terms and conditions of the stock

options it grants to employees. The risk-free rate is based on the U.S. Treasury yield curve for the periods within the contractual life of the options in effect at the time of the grant. The Company also makes assumptions regarding estimated forfeitures that will impact the total compensation expenses recognized under the Plans.

## **8. INCOME TAXES**

The Company files its income taxes on a consolidated basis with its subsidiary. Income tax expense is the total of current year income tax due or refundable and the change in deferred tax assets and liabilities.

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the consolidated income statement. There have been no significant changes to unrecognized tax benefits or accrued interest and penalties for the six months ended June 30, 2016.

## **9. FAIR VALUE MEASUREMENT**

The Company measures fair value under the fair value hierarchy described below.

Level 1: Quoted prices for identical instruments traded in active exchange markets.

Level 2: Quoted prices (unadjusted) for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3: Model based techniques that use one significant assumption not observable in the market. These unobservable assumptions reflect the Company's estimates of assumptions that market participants would use on pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

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.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at June 30, 2016 and December 31, 2015 are as follows, in thousands:

|  | Carrying Value | Fair Value Measurements at June 30, 2016 |          |           | Total Fair Value |
|--|----------------|--|----------|-----------|------------------|
|  |                | Level 1                                  | Level 2  | Level 3   |                  |
| Using:   |                |  |          |           |                  |
| <u>Financial assets:</u>                           |                |  |          |           |                  |
| Cash and cash equivalents                          | \$40,965       | \$40,965                                 |          |           | \$40,965         |
| Investment securities                              | 99,426         |  | \$99,426 |           | 99,426           |
| Loans, net   | 426,679        |  |          | \$422,850 | 422,850          |
| FHLB stock   | 2,438          |  |          |           | N/A              |
| Accrued interest receivable                        | 1,800          | 2  | 381      | 1,417     | 1,800            |
| <u>Financial liabilities:</u>                      |                |  |          |           |                  |
| Deposits   | 534,634        | 483,532                                  | 51,084   |           | 534,616          |
| Repurchase agreements                              | 3,894          |  | 3,894    |           | 3,894            |
| Note payable                                       | 2,625          |  |          | 2,625     | 2,625            |
| Junior subordinated deferrable interest debentures | 10,310         |  |          | 6,215     | 6,215            |
| Accrued interest payable                           | 58             | 7  | 40       | 11        | 58               |

Fair Value Measurements at December 31,  
2015 Using:

|  | Carrying<br>Value | Level 1  | Level 2  | Level 3   | Total<br>Fair<br>Value |
|--|-------------------|----------|----------|-----------|------------------------|
| <b><u>Financial assets:</u></b>                    |                   |          |          |           |                        |
| Cash and cash equivalents                          | \$68,195          | \$68,195 |          |           | \$68,195               |
| Investment securities                              | 96,704            |          | \$96,704 |           | 96,704                 |
| Loans, net   | 396,833           |          |          | \$395,338 | 395,338                |
| FHLB stock   | 2,380             |          |          |           | N/A                    |
| Accrued interest receivable                        | 2,048             | 26       | 328      | 1,694     | 2,048                  |
| <b><u>Financial liabilities:</u></b>               |                   |          |          |           |                        |
| Deposits   | 527,276           | 475,013  | 52,287   |           | 527,300                |
| Repurchase agreements                              | 7,671             |          | 7,671    |           | 7,671                  |
| Note payable                                       | 4,875             |          |          | 4,875     | 4,875                  |
| Junior subordinated deferrable interest debentures | 10,310            |          |          | 6,662     | 6,662                  |
| Accrued interest payable                           | 58                | 8        | 38       | 12        | 58                     |

These estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The following methods and assumptions were used by management to estimate the fair value of its financial instruments:

**Cash and cash equivalents:** The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

**Investment securities:** Fair values for securities available for sale are generally determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2).

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

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

Deposits: The fair values disclosed for demand deposits, including interest and non-interest demand accounts, savings, and certain types of money market accounts are, by definition, equal to the carrying amount at the reporting date resulting in a Level 1 classification. 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 aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Repurchase agreements: The fair value of securities sold under repurchase agreements is estimated based on bid quotations received from brokers using observable inputs and are included as Level 2.

Note payable: The fair value of the Company's Note Payable is estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Junior subordinated deferrable interest debentures: The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Accrued interest and payable: The carrying amounts of accrued interest approximate fair value and are considered to be linked in classification to the asset or liability for which they relate.

Commitments to extend credit and letters of credit: The fair value of commitments are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not presented. Commitments to extend credit are primarily for variable rate loans and letters of credit.

Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. Those estimates that are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision are included in Level 3. Changes in assumptions could significantly affect the fair values presented.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring and non-recurring basis as of June 30, 2016 and December 31, 2015, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

Assets and liabilities measured at fair value on a recurring basis at June 30, 2016 are summarized below, in thousands:

|                        |  |   |  |
|------------------------|--|---|--|
| Total<br>Fair<br>Value | Fair Value Measurements at<br>June 30, 2016 Using<br>Quoted Prices<br>for<br>Identical<br>Assets | Significant<br>Other<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|------------------------|--|---|--|

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|   |          | (Level<br>1) |           |      |
|---|----------|--------------|-----------|------|
| Assets:   |          |              |           |      |
| U.S. Government-sponsored agencies  | \$3,003  | \$-          | \$ 3,003  | \$ - |
| U.S. Government-sponsored agencies collateralized by mortgage obligations-<br>residential | 71,148   |              | 71,148    |      |
| Obligations of states and political subdivisions  | 25,275   |              | 25,275    |      |
|   | \$99,426 | \$-          | \$ 99,426 | \$ - |

Assets and liabilities measured at fair value on a recurring basis at December 31, 2015 are summarized below, in thousands:

|   | Total<br>Fair<br>Value | Fair Value Measurements at<br>December 31, 2015 Using<br>Quoted<br>Prices |   |  |
|---|------------------------|---|---|--|
|   |                        | in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 2)        | Significant<br>Other<br>Observable<br>Inputs<br>(Level 3) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|   |                        | (Level<br>1)  |   |  |
| Assets:   |                        |   |   |  |
| U.S. Government- sponsored agencies   | \$1,977                | \$-   | \$ 1,977  | \$ -   |
| U.S. Government-sponsored agencies collateralized by mortgage obligations-<br>residential | 72,370                 |   | 72,370  |  |
| Obligations of states and political subdivisions  | 22,357                 |   | 22,357  |  |
|   | \$96,704               | \$-   | \$ 96,704   | \$ -   |



The fair value of securities available-for-sale equals quoted market price, if available. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities or matrix pricing. There were no changes in the valuation techniques used during 2016 or 2015. Transfers between hierarchy measurement levels are recognized by the Company as of the beginning of the reporting period. Changes in fair market value are recorded in other comprehensive income.

Assets and liabilities measured at fair value on a non-recurring basis at June 30, 2016 are summarized below, in thousands:

|   | Total Fair Value | Fair Value Measurements at June 30, 2016 Using Quoted   |   |   | Six Months Ended <u>June 30, 2016</u><br>Total Gains (Losses) |
|---|------------------|---|---|---|---|
|   |                  | Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |   |
| Assets:   |                  |   |   |   |   |
| Impaired loans:                                 |                  |   |   |   |   |
| Real estate – commercial                        | \$453            | \$-   | \$-   | \$ 453                                    | \$ (81 )  |
| Real estate – construction and land development | 22               |   |   | 22  | -   |
| Equity lines of credit                          | 83               |   |   | 83  | 4   |
| Total impaired loans                            | 558              | -   | -   | 558                                       | (77 )   |
| Other real estate:                              |                  |   |   |   |   |
| Real estate – commercial                        | 1,000            |   |   | 1,000                                     | (9 )  |
| Real estate – construction and land development | 1,817            |   |   | 1,817                                     | -   |
| Total other real estate                         | 2,817            | -   | -   | 2,817                                     | (9 )  |
|   | \$3,375          | \$-   | \$-   | \$ 3,375                                  | \$ (86 )  |

Assets and liabilities measured at fair value on a non-recurring basis at December 31, 2015 are summarized below, in thousands:

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Fair Value Measurements at  
December 31, 2015 Using  
Quoted

|   | Total<br>Fair<br>Value | Fair Value Measurements at<br>December 31, 2015 Using<br>Quoted                              |  |  | Six<br>Months<br>Ended<br><u>June 30,<br/>2015</u> |
|---|------------------------|--|--|--|--|
|   |                        | Prices<br>in<br>Significant<br>Active<br>Markets<br>for<br>Observable<br>Inputs<br>(Level 1) | Significant<br>Unobservable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |  |
| Assets:   |                        |  |  |  |  |
| Impaired loans:                                 |                        |  |  |  |  |
| Real estate – commercial                        | \$1,214                | \$-  | \$-  | \$ 1,214   | \$ (27 )   |
| Real estate – construction and land development | 30                     |  |  | 30   | (16 )  |
| Equity lines of credit                          | 83                     |  |  | 83   | 2  |
| Total impaired loans                            | 1,327                  | -  | -  | 1,327  | (41 )  |
| Other real estate:                              |                        |  |  |  |  |
| Commercial                                      | -                      | -  | -  | -  | (39 )  |
| Real estate – commercial                        | 156                    |  |  | 156  | (106 )   |
| Real estate – construction and land development | 1,516                  |  |  | 1,516  | 116  |
| Equity lines of credit                          | 84                     |  |  | 84   | (14 )  |
| Total other real estate                         | 1,756                  | -  | -  | 1,756  | (43 )  |
|   | \$3,083                | \$-  | \$-  | \$ 3,083   | \$ (84 )   |

The Company has no liabilities which are reported at fair value.

The following methods were used to estimate fair value.

**Collateral-Dependent Impaired Loans:** The Bank does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect partial write-downs, through charge-offs or specific reserve allowances, that are based on fair value estimates of the underlying collateral. The fair value estimates for collateral-dependent impaired loans are generally based on recent real estate appraisals or broker opinions, obtained from independent third parties, which are frequently adjusted by management to reflect current conditions and estimated selling costs (Level 3). Total losses of \$77,000 and \$41,000 represent impairment charges recognized during the six months ended June 30, 2016 and 2015, respectively, related to the above impaired loans.

**Other Real Estate:** Nonrecurring adjustments to certain real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized. Fair values are generally based on third party appraisals of the property which are commonly adjusted by management to reflect current conditions and selling costs (Level 3).

Appraisals for collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers whose qualifications and licenses have been reviewed and verified by the Bank. Once received, a member of the loan department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison to independent data sources such as recent market data or industry wide-statistics. The Bank also compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustments, if any, should be made to the appraisal values on any remaining other real estate owned to arrive at fair value. No significant adjustments to appraised values have been made as a result of this comparison process as of June 30, 2016.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at June 30, 2016 and December 31, 2015 (dollars in thousands):

| Description | Fair Value<br>6/30/2016 | Fair Value<br>12/31/2015 | Valuation<br>Technique | Significant<br>Unobservable<br>Input | Range<br>(Weighted<br>Average) | Range<br>(Weighted<br>Average) |
|-------------|-------------------------|--------------------------|------------------------|--------------------------------------|--------------------------------|--------------------------------|
|-------------|-------------------------|--------------------------|------------------------|--------------------------------------|--------------------------------|--------------------------------|

6/30/2016

12/31/2015

Collateral-Dependent  
Impaired Loans:

|   |          |          |                        |  |                 |                |
|---|----------|----------|------------------------|--|-----------------|----------------|
| Real estate – commercial                        | \$ 453   | \$ 1,214 | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | 12% (12%)       | 9% - 12% (10%) |
| Real estate – construction and land development | \$ 22    | \$ 30    | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | 10% (10%)       | 8% (8%)        |
| Equity lines of credit                          | \$ 83    | \$ 83    | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | 8% (8%)         | 8% (8%)        |
| Other Real Estate:                              |          |          |                        |  |                 |                |
| Real estate – construction and land development | \$ 1,817 | \$ 1,516 | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | 10% - 36% (23%) | 10% (10%)      |
| Real estate – commercial                        | \$ 1,000 | \$ 156   | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | 20% (20%)       | 10% (10%)      |
| Equity lines of credit                          | \$ -     | \$ 84    | Third Party Appraisals | Management Adjustments to Reflect Current Conditions and Selling Costs | N/A             | 10% (10%)      |

## 10. Adoption of New Accounting Standards

### Pending Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Customers. This update to the ASC is the culmination of efforts by the FASB and the International Accounting Standards Board (IASB) to develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards (IFRS). ASU 2014-09 supersedes Topic 605 – Revenue Recognition and most industry-specific guidance. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in ASU 2014-09 describes a 5-step process entities can apply to achieve the core principle of revenue recognition and requires disclosures sufficient to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers and the significant judgments used in determining that information.

This update was originally effective for annual reporting periods beginning on or after December 15, 2016 and interim periods therein and requires expanded disclosures. In July 2015 the FASB issued a deferral of ASU 2014-09 of one year making it effective for annual reporting periods beginning on or after December 15, 2017 while also providing for early adoption but not before the original effective date. The Company is currently evaluating the effects of ASU 2014-09 on its financial statements and disclosures, if any.

On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. Changes made to the current measurement model primarily affect the accounting for equity securities with readily determinable fair values, where changes in fair value will impact earnings instead of other comprehensive income. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The Update also changes the presentation and disclosure requirements for financial instruments including a requirement that public business entities use exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes. This Update is generally effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the effects of ASU 2016-01 on its financial statements and disclosures.

On February 25, 2016, the FASB issued ASU 2016-02, Leases. The most significant change for lessees is the requirement under the new guidance to recognize right-of-use assets and lease liabilities for all leases not considered short-term leases, which is generally defined as a lease term of less than 12 months. This change will result in lessees recognizing right-of-use assets and lease liabilities for most leases currently accounted for as operating leases under current lease accounting guidance. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018. The Company is currently evaluating the effects of ASU 2016-02 on its financial statements and

disclosures.

On March 30, 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting, which is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for interim and annual periods beginning after December 15, 2016. Early application is permitted. The Company is currently evaluating the effects of ASU 2016-09 on its financial statements and disclosures.

In June 2016, the FASB issued ASU No. 2016-13, Measurement of Credit Losses on Financial Instruments. ASU No. 2016-13 significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. The standard will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments, and financial guarantees. The CECL model does not apply to available-for-sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. ASU No. 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. ASU No. 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company is currently evaluating the provisions of ASU No. 2016-13 to determine the potential impact the new standard will have on its financial statements and disclosures.

## **PART I – FINANCIAL INFORMATION**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Certain matters discussed in this Quarterly Report are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, among others, (1) significant increases in competitive pressures in the financial services industry; (2) changes in the interest rate environment resulting in reduced margins; (3) general economic conditions, either nationally or regionally, maybe less favorable than expected, resulting in, among other things, a deterioration in credit quality; (4) changes in regulatory environment; (5) loss of key personnel; (6) fluctuations in the real estate market; (7) changes in business conditions and inflation; (8) operational risks including data processing systems failures or fraud; and (9) changes in securities markets. Therefore, the information set forth herein should be carefully considered when evaluating the business prospects of Plumas Bancorp (the “Company”).

When the Company uses in this Quarterly Report the words “anticipate”, “estimate”, “expect”, “project”, “intend”, “commit”, “believe” and similar expressions, the Company intends to identify forward-looking statements. Such statements are not guarantees of performance and are subject to certain risks, uncertainties and assumptions, including those described in this Quarterly Report. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, expected, projected, intended, committed or believed. The future results and stockholder values of the Company may differ materially from those expressed in these forward-looking statements. Many of the factors that will determine these results and values are beyond the Company’s ability to control or predict. For those statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

## **INTRODUCTION**

The following discussion and analysis sets forth certain statistical information relating to the Company as of June 30, 2016 and December 31, 2015 and for the six and three month periods ended June 30, 2016 and 2015. This discussion should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and the consolidated financial statements and notes thereto included in Plumas Bancorp’s Annual Report filed on Form 10-K for the year ended December 31, 2015.

Plumas Bancorp trades on The NASDAQ Capital Market under the ticker symbol “PLBC”.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

There have been no changes to the Company's critical accounting policies from those disclosed in the Company's 2015 Annual Report to Shareholders on Form 10-K.

This discussion should be read in conjunction with our unaudited condensed consolidated financial statements, including the notes thereto, appearing elsewhere in this report.



## OVERVIEW - SIX MONTHS ENDED JUNE 30, 2016

Net income increased by \$840 thousand from \$2.6 million during the six months ended June 30, 2015 to \$3.4 million during the current six month period. Earnings benefited from increases of \$1.3 million in net interest income and declines of \$22 thousand in non-interest expense and \$200 thousand in the provision for loan losses. Partially offsetting these items was a decline in non-interest income of \$160 thousand and an increase in income tax expense of \$496 thousand. Diluted earnings per share increased to \$0.67 for the six months ended June 30, 2016 compared to \$0.51 during the six months ended June 30, 2015.

Total assets at June 30, 2016 were \$604 million, an increase of \$4.8 million from December 31, 2015. Loan growth was exceptionally strong during the first six months of 2016 with net loans increasing by \$29.8 million from \$397 million at December 31, 2015 to \$427 million at June 30, 2016. The largest reduction in assets was a decline in cash and cash equivalents totaling \$27.2 million from \$68.2 million at December 31, 2015 to \$41.0 million at June 30, 2016.

Deposits totaled \$534.6 million at June 30, 2016, an increase of \$7.3 million from \$527.3 million at December 31, 2015. Increases included \$1.2 million in non-interest bearing demand deposits and \$8.6 million in savings and money market accounts. Interest bearing transaction accounts (NOW) accounts declined by \$1.3 million and time deposits declined by \$1.2 million. Shareholders' equity increased by \$3.9 million from \$42.5 million at December 31, 2015 to \$46.4 million at June 30, 2016.

The annualized return on average assets was 1.15% for the six months ended June 30, 2016 up from 0.94% for the six months ended June 30, 2015. The annualized return on average equity increased from 13.5% during the first six months of 2015 to 15.3% during the current six month period.

The following is a detailed discussion of each component affecting change in net income and the composition of our balance sheet.

## RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2016

**Net interest income before provision for loan losses.** Net interest income, on a nontax-equivalent basis, for the six months ended June 30, 2016 was \$11.6 million, an increase of \$1.3 million from the \$10.3 million earned during the same period in 2015. The increase in net interest income includes an increase of \$1.1 million in interest income and a decline of \$167 thousand in interest expense. Net interest margin, which benefited from a 12 basis points decline in

average rate paid on interest bearing liabilities, increased 7 basis points to 4.23%, up from 4.16% for the same period in 2015.

Interest income increased by 10% to \$12.1 million for the six months ended June 30, 2016, up from \$11.0 million during the same period in 2015. Mostly related to an increase in loan balances, interest and fees on loans increased by \$919 thousand to \$11.0 million for the six months ended June 30, 2016; compared to \$10.1 million during the first half of 2015. The Company's average loan balances were \$411 million for the six months ended June 30, 2016, up \$32 million, or 8%, from \$379 million for the same period in 2015.

The following table compares loan balances by type at June 30, 2016 and 2015.

|                               | Balance<br>at End of<br>Period | Percent<br>of Loans | Balance<br>at End of<br>Period | Percent<br>of Loans |   |
|-------------------------------|--------------------------------|---------------------|--------------------------------|---------------------|---|
|                               |                                | in Each<br>Category |                                | in Each<br>Category |   |
| <u>(dollars in thousands)</u> |                                | Total<br>Loans      |                                | Total<br>Loans      |   |
|                               | <b>06/30/16</b>                | <b>06/30/16</b>     | <b>06/30/15</b>                | <b>06/30/15</b>     |   |
| Commercial                    | \$41,083                       | 9.6                 | % \$36,458                     | 9.3                 | % |
| Agricultural                  | 47,069                         | 10.9                | % 38,542                       | 9.8                 | % |
| Real estate – residential     | 23,972                         | 5.6                 | % 27,346                       | 7.0                 | % |
| Real estate – commercial      | 204,477                        | 47.4                | % 174,258                      | 44.4                | % |
| Real estate – construction    | 18,635                         | 4.3                 | % 26,594                       | 6.8                 | % |
| Equity Lines of Credit        | 41,088                         | 9.5                 | % 38,634                       | 9.8                 | % |
| Auto                          | 51,386                         | 11.9                | % 47,425                       | 12.1                | % |
| Other                         | 3,574                          | 0.8                 | % 3,315                        | 0.8                 | % |
| Total Gross Loans             | \$431,284                      | 100                 | % \$392,572                    | 100                 | % |

The average rate earned on the Company's loan balances increased by 2 basis points to 5.39% during the first six months of 2016 compared to 5.37% during the first six months of 2015. We attribute this increase in yield to an increase of 25 basis points in the prime rate on December 17, 2015. Loan pricing continues to be extremely competitive in our service area.

Interest on investment securities increased by \$129 thousand as a result of an increase in yield of 9 basis points from 1.82% during the first half of 2015 to 1.91% during the six months ended June 30, 2016. The average balance in investment securities increased from \$90.3 million during the first half of 2015 to \$99.3 million during the six months ended June 30, 2016. During the current period yield benefited from an increase in municipal securities as a percentage of total securities and to a lesser extent a reduction in securities of U.S. Government-sponsored agencies. At June 30, 2016 municipal securities totaled \$25.3 million or 25% of the investment portfolio compared to \$15.9 million or 18% of the portfolio at June 30, 2015. U.S. Government-sponsored agencies were \$3.0 million at June 30, 2016 and \$6.1 million at June 30, 2015.

Interest expense on deposits increased by \$13 thousand, or 5%, to \$262 thousand for the six months ended June 30, 2016, up from \$249 thousand during the 2015 period. This increase relates to an increase in the average balance of NOW, Money Market and Savings accounts partially offset by decreases in the average balance and rate paid on time deposits.

Interest on time deposits declined by \$11 thousand. Average time deposits declined by \$3.3 million from \$54.8 million during the six months ended June 30, 2015 to \$51.5 million during the current period. We attribute much of the reduction in time deposit to the unusually low interest rate environment as we have seen a movement out of time into more liquid deposit types. The average rate paid on time deposits decreased from 0.33% during the six months ended June 30, 2015 to 0.31% during the current period. This decrease primarily relates to the maturity of higher rate time deposits.

The largest increase in interest expense on deposits was a \$14 thousand increase in interest on savings accounts related to growth in this deposit category. Average savings balances increased from \$112.1 million during the six months ended June 30, 2015 to \$128.1 million during the current six month period. Plumas Bank's savings accounts provide an attractive interest rate, in the current rate environment, and we have seen continued growth in savings accounts for the last few years. The average rate paid on savings accounts was 16 basis points during both periods.

Interest expense on other interest-bearing liabilities decreased by \$180 thousand from \$427 thousand during the six months ended June 30, 2015 to \$247 thousand during the current six month period. On April 15, 2013, to help fund the repurchase of preferred stock during 2013, the Company issued a \$7.5 million subordinated debenture. On April 16, 2015 we paid off the subordinated debenture resulting in a reduction in interest expense related to this debt of \$219 thousand.

Interest expense on the Company's note payable increased by \$21 thousand to \$76 thousand during the six months ended June 30, 2016. This increase was mostly related to an increase in average borrowings on this note from \$2.7 million during the 2015 period to \$4.0 million during the six months ended June 30, 2016. The average rate paid on the note payable was 3.80% during 2016 and 4.10% during the six months ended June 30, 2015.

Interest expense on junior subordinated debentures, which increased by \$19 thousand to \$169 thousand, fluctuates with changes in the 3-month London Interbank Offered Rate (LIBOR) rate.

The following table presents for the six-month periods indicated the distribution of consolidated average assets, liabilities and shareholders' equity. It also presents the amounts of interest income from interest-earning assets and the resultant annualized yields, as well as the amounts of interest expense on interest-bearing liabilities and the resultant cost expressed in both dollars and annualized rate percentages. Average balances are based on daily averages. Nonaccrual loans are included in the calculation of average loans while nonaccrued interest thereon is excluded from the computation of yields earned:

|                                      | For the Six Months Ended<br>June 30, 2016 |                               |                | For the Six Months Ended<br>June 30, 2015 |                               |                |
|--------------------------------------|---|-------------------------------|----------------|---|-------------------------------|----------------|
|                                      | Average<br>Balance<br>(in<br>thousands)   | Interest<br>(in<br>thousands) | Yield/<br>Rate | Average<br>Balance<br>(in<br>thousands)   | Interest<br>(in<br>thousands) | Yield/<br>Rate |
| <b>Interest-earning assets:</b>      |   |                               |                |   |                               |                |
| Loans (1) (2) (3)                    | \$411,024                                 | \$ 11,009                     | 5.39 %         | \$379,143                                 | \$ 10,090                     | 5.37 %         |
| Investment securities (1)            | 99,251                                    | 945                           | 1.91 %         | 90,346                                    | 816                           | 1.82 %         |
| Interest-bearing deposits            | 39,440                                    | 123                           | 0.63 %         | 29,308                                    | 64                            | 0.44 %         |
| Total interest-earning assets        | 549,715                                   | 12,077                        | 4.42 %         | 498,797                                   | 10,970                        | 4.44 %         |
| Cash and due from banks              | 16,001                                    |                               |                | 16,961                                    |                               |                |
| Other assets                         | 32,162                                    |                               |                | 33,170                                    |                               |                |
| Total assets                         | \$597,878                                 |                               |                | \$548,928                                 |                               |                |
| <b>Interest-bearing liabilities:</b> |   |                               |                |   |                               |                |
| NOW deposits                         | \$90,801                                  | 42                            | 0.09 %         | \$85,132                                  | 37                            | 0.09 %         |
| Money market deposits                | 52,175                                    | 37                            | 0.14 %         | 45,167                                    | 32                            | 0.14 %         |
| Savings deposits                     | 128,102                                   | 103                           | 0.16 %         | 112,081                                   | 89                            | 0.16 %         |
| Time deposits                        | 51,528                                    | 80                            | 0.31 %         | 54,839                                    | 91                            | 0.33 %         |
| Total deposits                       | 322,606                                   | 262                           | 0.16 %         | 297,219                                   | 249                           | 0.17 %         |
| Note Payable                         | 4,026                                     | 76                            | 3.80 %         | 2,703                                     | 55                            | 4.10 %         |
| Subordinated debentures              | -   | -                             | - %            | 4,334                                     | 219                           | 10.19 %        |
| Junior subordinated debentures       | 10,310                                    | 169                           | 3.30 %         | 10,310                                    | 150                           | 2.93 %         |
| Other interest-bearing liabilities   | 5,295                                     | 2                             | 0.08 %         | 7,192                                     | 3                             | 0.08 %         |
| Total interest-bearing liabilities   | 342,237                                   | 509                           | 0.30 %         | 321,758                                   | 676                           | 0.42 %         |
| Non-interest bearing deposits        | 204,671                                   |                               |                | 182,779                                   |                               |                |
| Other liabilities                    | 6,195                                     |                               |                | 5,999                                     |                               |                |
| Shareholders' equity                 | 44,775                                    |                               |                | 38,392                                    |                               |                |

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|   |           |        |           |        |
|---|-----------|--------|-----------|--------|
| Total liabilities & equity                  | \$597,878 |        | \$548,928 |        |
| Cost of funding interest-earning assets (4) |           | 0.19 % |           | 0.28 % |
| Net interest income and margin (5)          | \$ 11,568 | 4.23 % | \$ 10,294 | 4.16 % |

(1) Not computed on a tax-equivalent basis.

(2) Average nonaccrual loan balances of \$4.6 million for 2016 and \$6.0 million for 2015 are included in average loan balances for computational purposes.

(3) Net loan costs included in loan interest income for the six-month periods ended June 30, 2016 and 2015 were \$329,000 and \$353,000, respectively.

(4) Total annualized interest expense divided by the average balance of total earning assets.

(5) Annualized net interest income divided by the average balance of total earning assets.

The following table sets forth changes in interest income and interest expense for the six-month periods indicated and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates:

|                                      | <b>2016 over 2015 change in<br/>net interest income</b> |             |            |              |
|--------------------------------------|---|-------------|------------|--------------|
|                                      | <b>for the six months ended<br/>June 30</b>             |             |            |              |
|                                      | <b>(in thousands)</b>                                   |             |            |              |
|                                      | <b>Volume</b>   | <b>Rate</b> | <b>Mix</b> | <b>Total</b> |
|                                      | <b>(1)</b>  | <b>(2)</b>  | <b>(3)</b> |              |
| <b>Interest-earning assets:</b>      |   |             |            |              |
| Loans                                | \$851   | \$37        | \$31       | \$919        |
| Investment securities                | 81  | 42          | 6          | 129          |
| Interest bearing deposits            | 22  | 27          | 10         | 59           |
| Total interest income                | 954   | 106         | 47         | 1,107        |
| <b>Interest-bearing liabilities:</b> |   |             |            |              |
| NOW deposits                         | 3   | 2           | -          | 5            |
| Money market deposits                | 5   | -           | -          | 5            |
| Savings deposits                     | 13  | 1           | -          | 14           |
| Time deposits                        | (5 )  | (6 )        | -          | (11 )        |
| Note payable                         | 27  | (4 )        | (2 )       | 21           |
| Subordinated debentures              | (219 )  | -           | -          | (219 )       |
| Junior subordinated debentures       | -   | 19          | -          | 19           |
| Other                                | (1 )  | -           | -          | (1 )         |
| Total interest expense               | (177 )  | 12          | (2 )       | (167 )       |
| Net interest income                  | \$1,131   | \$94        | \$49       | \$1,274      |

(1) The volume change in net interest income represents the change in average balance multiplied by the previous year's rate.

(2) The rate change in net interest income represents the change in rate multiplied by the previous year's average balance.

(3) The mix change in net interest income represents the change in average balance multiplied by the change in rate.

**Provision for loan losses.** During the six months ended June 30, 2016 we recorded a provision for loan losses of \$400 thousand down \$200 thousand from the \$600 thousand provision recorded during the first half of 2015. See “Analysis of Asset Quality and Allowance for Loan Losses” for further discussion of loan quality trends and the provision for loan losses.

The allowance for loan losses is maintained at a level that management believes will be appropriate to absorb probable incurred losses on existing loans based on an evaluation of the collectability of the loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to repay their loan. The allowance for loan losses is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed not less than quarterly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Based on information currently available, management believes that the allowance for loan losses is appropriate to absorb probable incurred losses in the portfolio. However, no assurance can be given that the Company may not sustain charge-offs which are in excess of the allowance in any given period.



**Non-interest income.** During the six months ended June 30, 2016 non-interest income totaled \$3.7 million, a decrease of \$160 thousand from the six months ended June 30, 2015. The largest components of this change were decreases of \$82 thousand in gain on sale of SBA loans, \$78 thousand in other income related to a decrease of \$75 thousand in Federal Home Loan Bank of San Francisco (FHLB) dividends and \$62 thousand in loss/gain on sale of securities.

During the current period, proceeds from SBA loan sales totaled \$15.3 million resulting in a gain on sale of \$892 thousand. This compares to proceeds of \$14.0 million and a gain on sale of \$974 thousand during the first half of 2015. The decline in FHLB dividends was related to a \$88 thousand one-time special dividend from the FHLB paid in June, 2015. During the six months ended June 30, 2016 we sold fourteen investment securities recording a net loss of \$32 thousand. During the same period in 2015 we recorded a gain on sale of \$30 thousand from the sale of eight securities.

Loan servicing income, which increased by \$41 thousand, represents servicing income received on the guaranteed portion of SBA loans sold into the secondary market. At June 30, 2016 we were servicing \$92 million in guaranteed portions of loans an increase of \$11 million from \$81 million at June 30, 2015.

The following table describes the components of non-interest income for the six-month periods ended June 30, 2016 and 2015, dollars in thousands:

|                                     | <b>For the Six<br/>Months<br/>Ended June 30</b> |             | <b>Dollar</b> | <b>Percentage</b> |    |
|-------------------------------------|---|-------------|---------------|-------------------|----|
|                                     | <b>2016</b>                                     | <b>2015</b> | <b>Change</b> | <b>Change</b>     |    |
| Service charges on deposit accounts | \$1,965   | \$1,945     | \$ 20         | 1.0               | %  |
| Gain on sale of loans, net          | 892   | 974         | (82 )         | (8.4              | )% |
| Loan servicing fees                 | 303   | 262         | 41            | 15.6              | %  |
| Earnings on life insurance policies | 171   | 170         | 1             | 0.6               | %  |
| (Loss) gain on sale of investments  | (32 )   | 30          | (62 )         | (206.7            | )% |
| Other                               | 408   | 486         | (78 )         | (16.0             | )% |
| Total non-interest income           | \$3,707   | \$3,867     | \$ (160 )     | (4.1              | )% |

**Non-interest expense.** During the six months ended June 30, 2016 non-interest expense decreased by \$22 thousand to \$9.3 million. The largest components of this decrease were declines of \$92 thousand in OREO costs, \$57 thousand in loan and collections expenses and \$34 thousand in the provision from change in OREO valuation. The largest increases in non-interest expense were \$71 thousand in outside service fees and \$37 thousand in advertising expenses.

OREO costs which declined from \$99 thousand during the six months ended June 30, 2015 to \$7 thousand during the current six month period benefited from a reduction in OREO properties, a reimbursement of previously incurred costs and rental income on a new OREO property. The largest single decline in OREO costs was a decrease in OREO maintenance costs of \$62 thousand from \$70 thousand during the first half of 2015 to \$8 during the six months ended June 30, 2016. The decrease in loan collection expense was mostly related to a \$59 thousand increase, during the first quarter of 2015, in our reserve for losses on unfunded commitments which increased from \$141 thousand to \$200 thousand based on an analysis of this reserve. At June 30, 2016 the balance in the reserve was unchanged at \$200 thousand.

OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. When other real estate is acquired, any excess of the Bank's recorded investment in the loan balance and accrued interest income over the estimated fair market value of the property less costs to sell is charged against the allowance for loan losses. A valuation allowance for losses on other real estate is maintained to provide for temporary declines in value. The allowance is established through a provision for subsequent losses on other real estate which is included in other expenses. Subsequent gains or losses on sales or from impairment are recorded as incurred. The provision from change in OREO valuation declined from \$43 thousand during the six months ended June 30, 2015 to \$9 thousand during the current period. During the six months ended June 30, 2016 we recorded a \$9 thousand provision related to a decline in value on one OREO property.

Outside service fees increased by \$71 thousand from \$985 thousand during the six months ended June 30, 2015 to \$1.1 million during the current period. Outside service fees are mostly related to the outsourcing of item processing, statement processing, debit card processing, network administration, online banking, email processing and costs associated with the management of the Company's investment portfolio. The largest component of the increase in outside service costs during the current six month period was a \$26 thousand increase in debit card processing expense which was offset by a \$84 thousand increase in interchange income. The increase in advertising costs was mostly related to our new Reno, Nevada branch.

The following table describes the components of non-interest expense for the six-month periods ended June 30, 2016 and 2015, dollars in thousands:

|   | <b>For the Six<br/>Months<br/>Ended June 30</b> |             | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |    |
|---|---|-------------|--------------------------|------------------------------|----|
|   | <b>2016</b>                                     | <b>2015</b> |                          |                              |    |
| Salaries and employee benefits          | \$5,166   | \$5,144     | \$ 22                    | 0.4                          | %  |
| Occupancy and equipment                 | 1,384   | 1,380       | 4                        | 0.3                          | %  |
| Outside service fees                    | 1,056   | 985         | 71                       | 7.2                          | %  |
| Professional fees                       | 341   | 355         | (14 )                    | (3.9)                        | )% |
| Telephone and data communication        | 209   | 182         | 27                       | 14.8                         | %  |
| Advertising and shareholder relations   | 185   | 148         | 37                       | 25.0                         | %  |
| Deposit insurance                       | 174   | 188         | (14 )                    | (7.4)                        | )% |
| Director compensation and retirement    | 170   | 149         | 21                       | 14.1                         | %  |
| Business development                    | 162   | 165         | (3 )                     | (1.8)                        | )% |
| Armored car and courier                 | 118   | 114         | 4                        | 3.5                          | %  |
| Loan and collection expenses            | 73  | 130         | (57 )                    | (43.8)                       | )% |
| Stationery and supplies                 | 62  | 54          | 8                        | 14.8                         | %  |
| Insurance expense                       | 45  | 50          | (5 )                     | (10.0)                       | )% |
| Postage                                 | 20  | 20          | -                        | -                            | %  |
| Provision from change in OREO valuation | 9   | 43          | (34 )                    | (79.1)                       | )% |
| OREO costs                              | 7   | 99          | (92 )                    | (92.9)                       | )% |
| Gain on sale of OREO                    | 4   | (11 )       | 15                       | 136.4                        | %  |
| Other                                   | 128   | 140         | (12 )                    | (8.6)                        | )% |
| Total non-interest expense              | \$9,313   | \$9,335     | \$ (22 )                 | (0.2)                        | )% |

**Provision for income taxes.** The Company recorded an income tax provision of \$2.2 million, or 38.7% of pre-tax income for the six months ended June 30, 2016. This compares to an income tax provision of \$1.7 million, or 39.2% of pre-tax income for the six months ended June 30, 2015. The percentages for 2016 and 2015 differ from the statutory rate as tax exempt income such as earnings on Bank owned life insurance and municipal investment income decrease the tax provision.

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Based upon the analysis of available evidence, management has determined that it is "more likely than not" that all deferred income tax assets as of June 30, 2016 and December 31, 2015 will be fully realized and therefore no valuation allowance was recorded. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2016

**Net Income.** The Company recorded net income of \$1.8 million for the three months ended June 30, 2016 up \$482 thousand from net income of \$1.4 million for the three months ended June 30, 2015. Increases of \$513 thousand in net interest income and \$233 thousand in non-interest income and a decline of \$100 thousand in the loan loss provision were partially offset by increases of \$51 thousand in non-interest expense and \$313 thousand in the provision for income taxes.

The following is a detail discussion of each component of the change in net income.

**Net interest income before provision for loan losses.** Net interest income, on a nontax-equivalent basis, was \$5.8 million for the three months ended June 30, 2016 an increase of \$513 thousand, or 10%, from \$5.3 million for the same period in 2015. The increase in net interest income includes an increase of \$483 thousand in interest income and a decline of \$30 thousand in interest expense. Net interest margin for the three months ended June 30, 2016 and June 30, 2015 was 4.26%.

Interest income increased by 9%, to \$6.1 million for the three months ended June 30, 2016, up from \$5.6 million during the same period in 2015. Related to an increase in average loan balances, interest and fees on loans increased \$405 thousand to \$5.5 million for the three months ended June 30, 2016 as compared to \$5.1 million during the second quarter of 2015. The Company's average loan balances were \$420 million for the three months ended June 30, 2016, up \$33 million, or 8%, from \$387 million for the same period in 2015.

The average yield on loans was 5.32% during the second quarter of 2016 down from 5.34% for same quarter in 2015. We attribute much of the decrease in yield to price competition in our service area.

Interest on investment securities increased by \$55 thousand as a result of an increase in yield of 7 basis points from 1.83% during the second quarter of 2015 to 1.90% during the three months ended June 30, 2016 and an increase in average balance from \$91.4 million in 2015 to \$100.2 million in 2016. The increase in yield includes an increase in municipal securities as a percentage of total securities and a reduction in securities of U.S. Government-sponsored agencies.

Interest expense on deposits increased by \$5 thousand to \$130 thousand for the three months ended June 30, 2016, up from \$125 thousand during the 2015 quarter. This increase relates to an increase in average balance of NOW, Money Market and Savings accounts partially offset by decreases in the average balance and rate paid on time deposits.

Interest on time deposits declined by \$5 thousand. Average time deposits declined by \$2.6 million from \$53.8 million during the three months ended June 30, 2015 to \$51.2 million during the current quarter. We attribute much of the reduction in time deposits to the unusually low interest rate environment as we have seen a movement out of time into more liquid deposit types. The average rate paid on time deposits decreased from 0.33% during the three months ended June 30, 2015 to 0.31% during the current quarter. This decrease primarily relates to the maturity of higher rate deposits.

The largest increase in interest expense was an increase of \$6 thousand in interest on savings accounts related to growth in this deposit category. Average savings balances increased from \$115.3 million during the three months ended June 30, 2015 to \$128.5 million during the current quarter. Plumas Bank's savings accounts provide an attractive interest rate in the current rate environment and we have seen continued growth in savings accounts for the last few years. The average rate paid on savings accounts was 16 basis points during both periods.

Interest expense on other interest-bearing liabilities decreased by \$35 thousand from \$152 thousand during the three months ended June 30, 2015 to \$117 thousand during the current quarter related to the redemption of the Company's subordinated debenture on April 16, 2015 and a reduction in the average balance of the Company's note payable. Interest expense related to the subordinated debenture decreased by \$32 thousand. Interest expense on the Company's note payable decreased by \$13 thousand to \$31 thousand during the three months ended June 30, 2016. This decrease is related to a decrease in average borrowings on this note from \$4.4 million during the second quarter of 2015 to \$3.2 million during the three months ended June 30, 2016. The average rate paid on the note payable was 3.92% during the three months ended June 30, 2016 and 4.02% during the second quarter of 2015.

The following table presents for the three-month periods indicated the distribution of consolidated average assets, liabilities and shareholders' equity. It also presents the amounts of interest income from interest earning assets and the resultant annualized yields expressed in both dollars and annualized yield percentages, as well as, the amounts of interest expense on interest bearing liabilities and the resultant cost expressed in both dollars and annualized rate percentages. Average balances are based on daily averages. Nonaccrual loans are included in the calculation of average loans while nonaccrued interest thereon is excluded from the computation of yields earned:

|                                      | For the Three Months Ended |                   |                | For the Three Months Ended |                   |                |
|--------------------------------------|----------------------------|-------------------|----------------|----------------------------|-------------------|----------------|
|                                      | June 30, 2016              |                   |                | June 30, 2015              |                   |                |
|                                      | Average<br>Balance         | Interest          | Yield/<br>Rate | Average<br>Balance         | Interest          | Yield/<br>Rate |
|                                      | (in<br>thousands)          | (in<br>thousands) |                | (in<br>thousands)          | (in<br>thousands) |                |
| <b>Interest-earning assets:</b>      |                            |                   |                |                            |                   |                |
| Loans (1) (2) (3)                    | \$419,647                  | \$ 5,553          | 5.32 %         | \$386,924                  | \$ 5,148          | 5.34 %         |
| Investment securities (1)            | 100,243                    | 473               | 1.90 %         | 91,381                     | 418               | 1.83 %         |
| Other                                | 30,531                     | 51                | 0.67 %         | 21,941                     | 28                | 0.51 %         |
| Total interest-earning assets        | 550,421                    | 6,077             | 4.44 %         | 500,246                    | 5,594             | 4.49 %         |
| Cash and due from banks              | 16,249                     |                   |                | 17,510                     |                   |                |
| Other assets                         | 31,603                     |                   |                | 33,062                     |                   |                |
| Total assets                         | \$598,273                  |                   |                | \$550,818                  |                   |                |
| <b>Interest-bearing liabilities:</b> |                            |                   |                |                            |                   |                |
| NOW deposits                         | \$90,330                   | 20                | 0.09 %         | \$85,779                   | 19                | 0.09 %         |
| Money market deposits                | 53,262                     | 19                | 0.14 %         | 45,315                     | 16                | 0.14 %         |
| Savings deposits                     | 128,456                    | 52                | 0.16 %         | 115,259                    | 46                | 0.16 %         |
| Time deposits                        | 51,186                     | 39                | 0.31 %         | 53,807                     | 44                | 0.33 %         |
| Total deposits                       | 323,234                    | 130               | 0.16 %         | 300,160                    | 125               | 0.17 %         |
| Note payable                         | 3,180                      | 31                | 3.92 %         | 4,385                      | 44                | 4.02 %         |
| Subordinated debentures              | -                          | -                 | - %            | 1,235                      | 32                | 10.39 %        |
| Junior subordinated debentures       | 10,310                     | 85                | 3.32 %         | 10,310                     | 75                | 2.92 %         |
| Other interest-bearing liabilities   | 4,257                      | 1                 | 0.09 %         | 5,403                      | 1                 | 0.07 %         |
| Total interest-bearing liabilities   | 340,981                    | 247               | 0.29 %         | 321,493                    | 277               | 0.35 %         |
| Non-interest bearing deposits        | 205,890                    |                   |                | 184,559                    |                   |                |
| Other liabilities                    | 6,029                      |                   |                | 5,758                      |                   |                |
| Shareholders' equity                 | 45,373                     |                   |                | 39,008                     |                   |                |
| Total liabilities & equity           | \$598,273                  |                   |                | \$550,818                  |                   |                |

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|   |          |        |          |        |
|---|----------|--------|----------|--------|
| Cost of funding interest-earning assets (4) |          | 0.18 % |          | 0.23 % |
| Net interest income and margin (5)          | \$ 5,830 | 4.26 % | \$ 5,317 | 4.26 % |

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(1) Not computed on a tax-equivalent basis.

(2) Average nonaccrual loan balances of \$4.6 million for 2016 and \$5.8 million for 2015 are included in average loan balances for computational purposes.

(3) Net loan costs included in loan interest income for the three-month periods ended June 30, 2016 and 2015 were \$196,000 and \$203,000, respectively.

(4) Total annualized interest expense divided by the average balance of total earning assets.

(5) Annualized net interest income divided by the average balance of total earning assets.



The following table sets forth changes in interest income and interest expense for the three-month periods indicated and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates:

|                                      | <b>2016 over 2015 change in<br/>net interest income</b>          |             |               |              |
|--------------------------------------|--|-------------|---------------|--------------|
|                                      | <b>for the three months<br/>ended June 30<br/>(in thousands)</b> |             |               |              |
|                                      | <b>Volume</b>  | <b>Rate</b> | <b>Mix</b>    | <b>Total</b> |
|                                      | <b>(1)</b>   | <b>(2)</b>  | <b>(3)</b>    |              |
| <b>Interest-earning assets:</b>      |  |             |               |              |
| Loans                                | \$434  | \$(14)      | \$(15)        | \$405        |
| Investment securities                | 40   | 14          | 1             | 55           |
| Interest bearing deposits            | 11   | 9           | 3             | 23           |
| <b>Total interest income</b>         | <b>485</b>   | <b>9</b>    | <b>(11)</b>   | <b>483</b>   |
| <b>Interest-bearing liabilities:</b> |  |             |               |              |
| NOW deposits                         | 1  | -           | -             | 1            |
| Money market deposits                | 3  | -           | -             | 3            |
| Savings deposits                     | 5  | 1           | -             | 6            |
| Time deposits                        | (2 )   | (3 )        | -             | (5 )         |
| Note payable                         | (12 )  | (1 )        | -             | (13 )        |
| Subordinated debentures              | (32 )  | -           | -             | (32 )        |
| Junior subordinated debentures       | -  | 10          | -             | 10           |
| Other                                | -  | -           | -             | -            |
| <b>Total interest expense</b>        | <b>(37 )</b>   | <b>7</b>    | <b>-</b>      | <b>(30 )</b> |
| <b>Net interest income</b>           | <b>\$522</b>   | <b>\$2</b>  | <b>\$(11)</b> | <b>\$513</b> |

(1) The volume change in net interest income represents the change in average balance divided by the previous year's rate.

(2) The rate change in net interest income represents the change in rate divided by the previous year's average balance.

(3) The mix change in net interest income represents the change in average balance multiplied by the change in rate.

**Provision for loan losses.** During the three months ended June 30, 2016 we recorded a provision for loan losses of \$200 thousand, down \$100 thousand from the \$300 thousand provision recorded during the second quarter of 2015. See "Analysis of Asset Quality and Allowance for Loan Losses" for a discussion of loan quality trends and the provision for loan losses.

**Non-interest income.** During the three months ended June 30, 2016 non-interest income increased by \$233 thousand to \$2.0 million, up from \$1.8 million during the three months ended June 30, 2015. The largest component of this increase was an increase in gain on sale of SBA loans of \$242 thousand from \$317 thousand during the 2015 quarter to \$559 thousand during the three months ended June 30, 2016. Other increases included an increase in service charge income of \$28 thousand and an increase in loan servicing fees of \$18 thousand. These items were partially offset by a \$79 thousand decrease in dividends from the FHLB.

The following table describes the components of non-interest income for the three-month periods ended June 30, 2016 and 2015, dollars in thousands:

|                                     | <b>For the Three Months</b> |             |                      |                          |    |
|-------------------------------------|-----------------------------|-------------|----------------------|--------------------------|----|
|                                     | <b>Ended June 30</b>        |             |                      |                          |    |
|                                     | <b>2016</b>                 | <b>2015</b> | <b>Dollar Change</b> | <b>Percentage Change</b> |    |
| Service charges on deposit accounts | \$1,034                     | \$1,006     | \$ 28                | 2.8                      | %  |
| Gain on sale of loans, net          | 559                         | 317         | 242                  | 76.3                     | %  |
| Loan serving fees                   | 154                         | 136         | 18                   | 13.2                     | %  |
| Earnings on life insurance policies | 85                          | 85          | -                    | -                        | %  |
| Other                               | 223                         | 278         | (55 )                | (19.8                    | )% |
| Total non-interest income           | \$2,055                     | \$1,822     | \$ 233               | 12.8                     | %  |

**Non-interest expense.** During the three months ended June 30, 2016, non-interest expense totaled \$4.7 million, an increase of \$51 thousand from \$4.6 million during the second quarter of 2015. The two largest increases were \$132 thousand in salary and benefit expense and \$59 thousand in outside service fees. Salary expense increased by \$75 thousand which included annual merit increases and additional lending personnel including a new commercial/agricultural loan officer located in Klamath Falls, Oregon. Bonus expense increased by \$73 thousand to \$208 thousand during the second quarter related to the increase in Company profitability. Commission expense related to an increase in SBA loan sales, increased by \$96 thousand. These items were partially offset by an increase in deferred loan origination costs of \$170 thousand related to an increase in loan production. The increase in outside service fees included a \$31 thousand increase in debit card processing expense which was offset by an increase in interchange income.

These increases in non-interest expense were offset by a \$172 thousand decline in the provision from change in OREO valuation and a \$60 thousand decline in OREO costs. The provision from change in OREO valuation decreased from \$172 thousand during the second quarter of 2015 to \$0 during the current quarter. The \$172 thousand provision recorded during the second quarter of 2015 was related to declines in value in five properties the largest of which was \$81 thousand on one land development property. OREO costs which declined from \$46 thousand during the 2015 quarter to a credit of \$14 thousand during the three months ended June 30, 2016 benefited from a reduction in OREO properties, a reimbursement of previously incurred costs and rental income on a new OREO property.

The following table describes the components of non-interest expense for the three-month periods ended June 30, 2016 and 2015, dollars in thousands:

**For the Three  
Months**

**Ended June 30,**

|   | <b>2016</b> | <b>2015</b> | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |    |
|---|-------------|-------------|--------------------------|------------------------------|----|
| Salaries and employee benefits          | \$2,558     | \$2,426     | \$ 132                   | 5.4                          | %  |
| Occupancy and equipment                 | 677         | 680         | (3 )                     | (0.4                         | )% |
| Outside service fees                    | 550         | 491         | 59                       | 12.0                         | %  |
| Professional fees                       | 192         | 180         | 12                       | 6.7                          | %  |
| Telephone and data communication        | 110         | 93          | 17                       | 18.3                         | %  |
| Advertising and shareholder relations   | 100         | 81          | 19                       | 23.5                         | %  |
| Deposit insurance                       | 88          | 93          | (5 )                     | (5.4                         | )% |
| Business development                    | 87          | 82          | 5                        | 6.1                          | %  |
| Director compensation and retirement    | 85          | 73          | 12                       | 16.4                         | %  |
| Armored car and courier                 | 60          | 59          | 1                        | 1.7                          | %  |
| Loan and collection expenses            | 54          | 28          | 26                       | 92.9                         | %  |
| Stationery and supplies                 | 29          | 26          | 3                        | 11.5                         | %  |
| Insurance expense                       | 22          | 21          | 1                        | 4.8                          | %  |
| Postage                                 | 10          | 11          | (1 )                     | (9.1                         | )% |
| Provision from change in OREO valuation | -           | 172         | (172 )                   | (100.0                       | )% |
| Gain on sale of OREO                    | 4           | (8 )        | 12                       | 150.0                        | %  |
| OREO costs                              | (14 )       | 46          | (60 )                    | (130.4                       | )% |
| Other                                   | 68          | 75          | (7 )                     | (9.3                         | )% |
| Total non-interest expense              | \$4,680     | \$4,629     | \$ 51                    | 1.1                          | %  |

**Provision for income taxes.** The Company recorded income tax expense of \$1.2 million, or 38.9% of pre-tax income for the three months ended June 30, 2016. This compares to income tax expense of \$855 thousand, or 38.7% of pre-tax income for the three months ended June 30, 2015. The percentages for 2016 and 2015 differ from the statutory rate as tax exempt income such as earnings on Bank owned life insurance and municipal loan and investment income decrease taxable income.

## FINANCIAL CONDITION

**Loan Portfolio.** Net loans increased by \$29.8 million or an annualized rate 15%, from \$397 million at December 31, 2015 to \$427 million at June 30, 2016. The largest areas of growth were \$12.4 million in commercial real estate loans and \$7.2 million in agricultural loans. The largest decrease in any loan category was a decline of \$1.5 million in residential real estate loans. The Company continues to manage the mix of its loan portfolio consistent with its identity as a community bank serving the financing needs of all sectors of the area it serves. Although the Company offers a broad array of financing options, it continues to concentrate its focus on small to medium sized commercial businesses. These loans offer diversification as to industries and types of businesses, thus limiting material exposure in any industry concentrations. The Company offers both fixed and floating rate loans and obtains collateral in the form of real property, business assets and deposit accounts, but looks to business and personal cash flows as its primary source of repayment.

As shown in the following table the Company's largest lending categories are commercial real estate loans, auto loans, agricultural loans, equity lines of credit and commercial loans.

|                                   | Balance<br>at<br>End of<br>Period | Percent<br>of<br>Loans in<br>Each<br>Category<br>to | Balance<br>at<br>End of<br>Period | Percent<br>of<br>Loans in<br>Each<br>Category<br>to |
|-----------------------------------|-----------------------------------|---|-----------------------------------|---|
|                                   |                                   | Total<br>Loans<br>6/30/16                           |                                   | Total<br>Loans<br>12/31/15                          |
| Commercial                        | \$41,083                          | 9.6 %   | \$37,084                          | 9.2 %   |
| Agricultural                      | 47,069                            | 10.9 %  | 39,856                            | 9.9 %   |
| Real estate - residential         | 23,972                            | 5.6 %   | 25,474                            | 6.4 %   |
| Real estate - commercial          | 204,477                           | 47.4 %  | 192,095                           | 47.9 %  |
| Real estate - construction & land | 18,635                            | 4.3 %   | 16,188                            | 4.0 %   |

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|                        |           |      |   |           |      |   |
|------------------------|-----------|------|---|-----------|------|---|
| Equity Lines of Credit | 41,088    | 9.5  | % | 38,327    | 9.6  | % |
| Auto                   | 51,386    | 11.9 | % | 48,365    | 12.1 | % |
| Other                  | 3,574     | 0.8  | % | 3,582     | 0.9  | % |
| Total Gross Loans      | \$431,284 | 100  | % | \$400,971 | 100  | % |

Construction and land development loans represented 4.3% and 4.0% of the loan portfolio as of June 30, 2016 and December 31, 2015, respectively. The construction and land development portfolio component has been identified by Management as a higher-risk loan category. The quality of the construction and land development category is highly dependent on property values both in terms of the likelihood of repayment once the property is transacted by the current owner as well as the level of collateral the Company has securing the loan in the event of default. Loans in this category are characterized by the speculative nature of commercial and residential development properties and can include property in various stages of development from raw land to finished lots. The decline in these loans as a percentage of the Company's loan portfolio from over 21% at December 31, 2007 to less than 7% during the last two years reflects management's efforts, which began in 2009, to reduce its exposure to construction and land development loans.

The Company's real estate related loans, including real estate mortgage loans, real estate construction and land development loans, consumer equity lines of credit, and agricultural loans secured by real estate comprised 72% of the total loan portfolio at June 30, 2016. Moreover, the business activities of the Company currently are focused in the California counties of Plumas, Nevada, Placer, Lassen, Modoc, Shasta, and Sierra and in Washoe County in Northern Nevada. Consequently, the results of operations and financial condition of the Company are dependent upon the general trends in these economies and, in particular, the residential and commercial real estate markets. In addition, the concentration of the Company's operations in these areas of Northeastern California and Northwestern Nevada exposes it to greater risk than other banking companies with a wider geographic base in the event of catastrophes, such as earthquakes, fires and floods in these regions.

The rates of interest charged on variable rate loans are set at specific increments in relation to the Company's lending rate or other indexes such as the published prime interest rate or U.S. Treasury rates and vary with changes in these indexes. The frequency in which variable rate loans reprice can vary from one day to several years. At June 30, 2016 and December 31, 2015, approximately 73% and 72%, respectively of the Company's loan portfolio was comprised of variable rate loans. At June 30, 2016 and December 31, 2015, 43% and 39%, respectively of the variable loans were at their respective floor rate. While real estate mortgage, commercial and consumer lending remain the foundation of the Company's historical loan mix, some changes in the mix have occurred due to the changing economic environment and the resulting change in demand for certain loan types. The most significant change has been an increase in indirect auto lending with automobile loans increasing from 2.5% of gross loans at December 31, 2011 to 11.9% of gross loans at June 30, 2016. The automobile portfolio provides diversification to the loan portfolio in terms of rate, term and balance as these loans tend to have a much shorter term and balance than commercial real-estate loans and are fixed rate. In addition, the Company remains committed to the agricultural industry in Northeastern California and will continue to pursue high quality agricultural loans. Agricultural loans include both commercial and commercial real estate loans. The Company's agricultural loan balances totaled \$47 million at June 30, 2016 and \$40 million at December 31, 2015. In 2016 we hired in a new agricultural/commercial loan officer located in Klamath Falls, Oregon. The increase in agricultural loans during 2016 is mostly attributable to his efforts.

**Analysis of Asset Quality and Allowance for Loan Losses.** The Company attempts to minimize credit risk through its underwriting and credit review policies. The Company's credit review process includes internally prepared credit reviews as well as contracting with an outside firm to conduct periodic credit reviews. The Company's management and lending officers evaluate the loss exposure of classified and impaired loans on a quarterly basis, or more frequently as loan conditions change. The Management Asset Resolution Committee (MARC) reviews the asset quality of criticized and past due loans on a monthly basis and reports the findings to the full Board of Directors. In management's opinion, this loan review system helps facilitate the early identification of potential criticized loans.

The Company has implemented MARC to develop an action plan to significantly reduce nonperforming assets. It consists of the Bank's Chief Executive Officer, Chief Financial Officer and Chief Credit Officer, and the activities are governed by a formal written charter. The MARC meets at least monthly and reports to the Board of Directors.

More specifically, a formal plan to effect repayment and/or disposition of every significant nonperforming loan relationship is developed and documented for review and on-going oversight by the MARC. Some of the strategies used include but are not limited to: 1) obtaining additional collateral, 2) obtaining additional investor cash infusion, 3) sale of the promissory note to an outside party, 4) proceeding with foreclosure on the underlying collateral, and 5) legal action against borrower/guarantors to encourage settlement of debt and/or collect any deficiency balance owed. Each step includes a benchmark timeline to track progress.

MARC also provides guidance for the maintenance and timely disposition of OREO properties; including developing financing and marketing programs to incent individuals to purchase OREO.

The allowance for loan losses is established through charges to earnings in the form of the provision for loan losses. Loan losses are charged to and recoveries are credited to the allowance for loan losses. The allowance for loan losses is maintained at a level deemed appropriate by management to provide for known and inherent risks in the loan portfolio. The adequacy of the allowance for loan losses is based upon management's continuing assessment of various factors affecting the collectability of loans; including current economic conditions, maturity of the portfolio, size of the portfolio, industry concentrations, borrower credit history, collateral, the existing allowance for loan losses, independent credit reviews, current charges and recoveries to the allowance for loan losses and the overall quality of the portfolio as determined by management, regulatory agencies, and independent credit review consultants retained by the Company. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The collectability of a loan is subjective to some degree, but must relate to the borrower's financial condition, cash flow, quality of the borrower's management expertise, collateral and guarantees, and state of the local economy.

Formula allocations are calculated by applying loss factors to outstanding loans with similar characteristics. Loss factors are based on the Company's historical loss experience as adjusted for changes in the business cycle and may be adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Historical loss data from the beginning of the latest business cycle are incorporated in the loss factors.



The discretionary allocation is based upon management's evaluation of various loan segment conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

The following table provides certain information for the dates indicated with respect to the Company's allowance for loan losses as well as charge-off and recovery activity.

|   | <b>For the Six<br/>Months Ended<br/>June 30,</b> |             | <b>For the Year Ended<br/>December 31</b> |             |             |
|---|--|-------------|---|-------------|-------------|
|   | <b>2016</b>                                      | <b>2015</b> | <b>2015</b>                               | <b>2014</b> | <b>2013</b> |
|   | <i>(dollars in thousands)</i>                    |             |   |             |             |
| Balance at beginning of period  | \$6,078  | \$5,451     | \$5,451                                   | \$5,517     | \$5,686     |
| Charge-offs:  |  |             |   |             |             |
| Commercial and agricultural   | 73   | 57          | 91  | 191         | 401         |
| Real estate mortgage  | 252  | 53          | 132                                       | 1,015       | 419         |
| Real estate construction & land   | -  | 55          | 55  | 106         | 735         |
| Consumer (includes Equity Lines of Credit & Auto)   | 205  | 285         | 549                                       | 601         | 360         |
| Total charge-offs   | 530  | 450         | 827                                       | 1,913       | 1,915       |
| Recoveries:   |  |             |   |             |             |
| Commercial and agricultural   | 17   | 90          | 173                                       | 89          | 140         |
| Real estate mortgage  | 38   | 4           | 8   | 19          | 109         |
| Real estate construction & land   | 329  | -           | -   | 491         | -           |
| Consumer (includes Equity Lines of Credit & Auto)   | 98   | 85          | 173                                       | 148         | 97          |
| Total recoveries  | 482  | 179         | 354                                       | 747         | 346         |
| Net charge-offs   | (48 )  | (271 )      | (473 )                                    | (1,166)     | (1,569)     |
| Provision for loan losses   | 400  | 600         | 1,100                                     | 1,100       | 1,400       |
| Balance at end of period  | \$6,430  | \$5,780     | \$6,078                                   | \$5,451     | \$5,517     |
| Net charge-offs during the period to average loans (annualized for the six month periods) | 0.02 %   | 0.14 %      | 0.12 %                                    | 0.33 %      | 0.49 %      |
| Allowance for loan losses to total loans  | 1.49 %   | 1.47 %      | 1.52 %                                    | 1.47 %      | 1.63 %      |

During the six months ended June 30, 2016 we recorded a provision for loan losses of \$400 thousand down \$200 thousand from the \$600 thousand provision recorded during the six months ended June 30, 2015. Net charge-offs totaled \$48 thousand a decrease of \$223 thousand from \$271 thousand during the six months ended June 30, 2015.

The following table provides a breakdown of the allowance for loan losses at June 30, 2016 and December 31, 2015:

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|   | Percent<br>of                     |                                    | Percent<br>of                     |                                    |   |
|---|-----------------------------------|------------------------------------|-----------------------------------|------------------------------------|---|
|   | Balance<br>at<br>End of<br>Period | Loans in<br>Each<br>Category<br>to | Balance<br>at<br>End of<br>Period | Loans in<br>Each<br>Category<br>to |   |
|   | <b>2016</b>                       | <b>2016</b>                        | <b>2015</b>                       | <b>2015</b>                        |   |
| Commercial and agricultural                       | \$ 1,251                          | 20.5                               | % \$ 933                          | 19.1                               | % |
| Real estate mortgage                              | 2,787                             | 53.0                               | % 2,866                           | 54.3                               | % |
| Real estate construction & land                   | 883                               | 4.3                                | % 874                             | 4.0                                | % |
| Consumer (includes Equity Lines of Credit & Auto) | 1,509                             | 22.2                               | % 1,405                           | 22.6                               | % |
| Total   | \$ 6,430                          | 100.0                              | % \$ 6,078                        | 100.0                              | % |

The allowance for loan losses totaled \$6.4 million at June 30, 2016 and \$6.1 million at December 31, 2015. Specific reserves related to impaired loans decreased by \$209 thousand from \$751 thousand at December 31, 2015 to \$542 thousand at June 30, 2016. This decline primarily results from one loan which was transferred to OREO during June 2016. At least quarterly the Company evaluates each specific reserve and if it determines that the loss represented by the specific reserve is uncollectable it records a charge-off for the uncollectable portion. General reserves were \$5.9 million at June 30, 2016 and \$5.3 million at December 31, 2015. The allowance for loan losses as a percentage of total loans decreased slightly from 1.52% at December 31, 2015 to 1.49% at June 30, 2016; however, the percentage of general reserves to unimpaired loans increased to 1.38% at June 30, 2016 from 1.35% at December 31, 2015.

The Company places loans 90 days or more past due on nonaccrual status unless the loan is well secured and in the process of collection. A loan is considered to be in the process of collection if, based on a probable specific event, it is expected that the loan will be repaid or brought current. Generally, this collection period would not exceed 90 days. When a loan is placed on nonaccrual status the Company's general policy is to reverse and charge against current income previously accrued but unpaid interest. Interest income on such loans is subsequently recognized only to the extent that cash is received and future collection of principal is deemed by management to be probable. Where the collectability of the principal or interest on a loan is considered to be doubtful by management, it is placed on nonaccrual status prior to becoming 90 days delinquent.

Impaired loans are measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary difference between impaired loans and nonperforming loans is that impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but also may include identified problem loans other than delinquent loans where it is considered probable that we will not collect all amounts due to us (including both principal and interest) in accordance with the contractual terms of the loan agreement.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Company, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

Loans restructured (TDRs) and not included in nonperforming loans in the following table totaled \$2.8 million at June 30, 2016 and \$2.0 million, \$2.0 million, \$4.5 million and \$5.4 million at December 31, 2015, 2014, 2013 and 2012, respectively.

The following table sets forth the amount of the Company's nonperforming assets as of the dates indicated.

|  | <b>At<br/>June<br/>30,<br/>2016</b> | <b>At December 31,</b> |          | <b>2013</b> | <b>2012</b> |  |  |  |
|--|-------------------------------------|------------------------|----------|-------------|-------------|--|--|--|
|  | <b>2015</b>                         | <b>2014</b>            |          |             |             |  |  |  |
|  | <i>(dollars in thousands)</i>       |                        |          |             |             |  |  |  |
| Nonaccrual loans   | \$2,968                             | \$4,546                | \$6,625  | \$5,519     | \$13,683    |  |  |  |
| Loans past due 90 days or more and still accruing            | -                                   | -                      | -        | 17          | 15          |  |  |  |
| Total nonperforming loans                                    | 2,968                               | 4,546                  | 6,625    | 5,536       | 13,698      |  |  |  |
| Other real estate owned                                      | 2,817                               | 1,756                  | 3,590    | 6,399       | 5,295       |  |  |  |
| Other vehicles owned   | 11                                  | 30                     | 13       | 60          | 41          |  |  |  |
| Total nonperforming assets                                   | \$5,796                             | \$6,332                | \$10,228 | \$11,995    | \$19,034    |  |  |  |
| Interest income forgone on nonaccrual loans                  | \$106                               | \$303                  | \$345    | \$280       | \$646       |  |  |  |
| Interest income recorded on a cash basis on nonaccrual loans | \$-                                 | \$-                    | \$31     | \$22        | \$192       |  |  |  |
| Nonperforming loans to total loans                           | 0.69 %                              | 1.13 %                 | 1.79 %   | 1.64 %      | 4.35 %      |  |  |  |
| Nonperforming assets to total assets                         | 0.96 %                              | 1.06 %                 | 1.90 %   | 2.33 %      | 3.98 %      |  |  |  |

Nonperforming loans at June 30, 2016 were \$3.0 million, a decrease of \$1.5 million from the \$4.5 million balance at December 31, 2015. The two largest decreases from the December 31, 2015 balance were the return to accrual status of one loan with a balance of \$618 thousand at December 31, 2015 and the transfer of one loan to OREO which had a balance of \$1.1 million at December 31, 2015. Specific reserves on nonaccrual loans totaled \$475 thousand at June 30, 2016 and \$683 thousand at December 31, 2015, respectively. Performing loans past due thirty to eighty-nine days were \$1.7 million at June 30, 2016 and \$1.5 million at December 31, 2015.

A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Total substandard loans decreased by \$2.2 million from \$6.0 million at December 31, 2015 to \$3.8 million at June 30, 2016. Loans classified as watch increased by \$224 thousand from \$4.1 million at December 31, 2015 to \$4.3 million at June 30, 2016. At June 30, 2016, \$0.9 million of performing loans were classified as substandard. Further deterioration in the credit quality of individual performing substandard loans or other adverse circumstances could result in the need to place these loans on nonperforming status.

At June 30, 2016 and December 31, 2015, the Company's recorded investment in impaired loans totaled \$5.7 million and \$6.5 million, respectively. The specific allowance for loan losses related to impaired loans totaled \$542 thousand and \$751 thousand at June 30, 2016 and December 31, 2015, respectively. Additionally, \$0.7 million has been charged off against the impaired loans at June 30, 2016 and December 31, 2015.

It is the policy of management to make additions to the allowance for loan losses so that it remains appropriate to absorb the inherent risk of loss in the portfolio. Management believes that the allowance at June 30, 2016 is appropriate. However, the determination of the amount of the allowance is judgmental and subject to economic conditions which cannot be predicted with certainty. Accordingly, the Company cannot predict whether charge-offs of loans in excess of the allowance may occur in future periods.

OREO represents real property acquired by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. Repossessed assets include vehicles and other commercial assets acquired under agreements with delinquent borrowers. OREO holdings represented eight properties totaling \$2.8 million at June 30, 2016 and seven properties totaling \$1.8 million at December 31, 2015. Nonperforming assets as a percentage of total assets were 0.96% at June 30, 2016 and 1.06% at December 31, 2015.

The following table provides a summary of the change in the number and balance of OREO properties for the six months ended June 30, 2016 and 2015, dollars in thousands:

**Six Months Ended June  
30,**

|   | #   | 2016    | #   | 2015    |
|---|-----|---------|-----|---------|
| Beginning Balance                       | 7   | \$1,756 | 15  | \$3,590 |
| Additions                               | 3   | 1,166   | 3   | 246     |
| Dispositions                            | (2) | (96 )   | (4) | (823 )  |
| Provision from change in OREO valuation |     | (9 )    |     | (43 )   |
| Ending Balance                          | 8   | \$2,817 | 14  | \$2,970 |

**Investment Portfolio and Federal Funds Sold.** Total investment securities were \$99.4 million at June 30, 2016 and \$96.7 million as of December 31, 2015. During the six months ended June 30, 2016 the Company sold fourteen available-for-sale investment securities for total proceeds of \$14.6 million recording a \$32 thousand net loss on sale. During the six months ended June 30, 2015 we sold eight available-for-sale investment securities having a value of \$6.7 million and recorded a net gain of \$30 thousand. The investment portfolio at June 30, 2016 consisted of \$74.2 million in securities of U.S. Government-sponsored agencies and 92 municipal securities totaling \$25.2 million. Included in the \$96.7 million at December 31, 2015 were \$74.3 million in securities of U.S. Government-sponsored agencies and 83 municipal securities totaling \$22.4 million.

There were no Federal funds sold at June 30, 2016 and December 31, 2015; however, the Bank maintained interest earning balances at the Federal Reserve Bank of San Francisco totaling \$15.6 million at June 30, 2016 and \$47.6 million at December 31, 2015. The interest rate earned on the balances at June 30, 2016 and December 31, 2015 was 0.5%.

The Company classifies its investment securities as available-for-sale or held-to-maturity. Currently all securities are classified as available-for-sale. Securities classified as available-for-sale may be sold to implement the Company's asset/liability management strategies and in response to changes in interest rates, prepayment rates and similar factors.

**Deposits.** Deposits totaled \$534.6 million at June 30, 2016, an increase of \$7.3 million from \$527.3 million at December 31, 2015. Increases included \$1.2 million in non-interest bearing demand deposits and \$8.6 million in savings and money market accounts. NOW accounts declined by \$1.3 million and time deposits declined by \$1.2 million. The Company continues to manage the mix of its deposits consistent with its identity as a community bank serving the financial needs of its customers.

The following table shows the distribution of deposits by type at June 30, 2016 and December 31, 2015.

| (dollars in thousands) | Balance at End of Period | Percent of Deposits in Each Category to Total |                    | Percent of Deposits in Each Category to Total |          |
|------------------------|--------------------------|---|--------------------|---|----------|
|                        |                          | 6/30/16                                       | 12/31/15           | 6/30/16                                       | 12/31/15 |
| Non-interest bearing   | \$210,262                | 39.3  | % \$209,044        | 39.6  | %        |
| NOW                    | 89,940                   | 16.8  | % 91,225           | 17.3  | %        |
| Money Market           | 54,480                   | 10.2  | % 48,848           | 9.3   | %        |
| Savings                | 128,851                  | 24.1  | % 125,896          | 23.9  | %        |
| Time                   | 51,101                   | 9.6   | % 52,263           | 9.9   | %        |
| <b>Total Deposits</b>  | <b>\$534,634</b>         | <b>100</b>                                    | <b>% \$527,276</b> | <b>100</b>                                    | <b>%</b> |

Deposits represent the Bank's primary source of funds. Deposits are primarily core deposits in that they are demand, savings and time deposits generated from local businesses and individuals. These sources are considered to be relatively stable, long-term relationships thereby enhancing steady growth of the deposit base without major fluctuations in overall deposit balances. The Company experiences, to a small degree, some seasonality with the slower growth period between November through April, and the higher growth period from May through October. In order to assist in meeting any funding demands, the Company maintains a secured borrowing arrangement with the FHLB. There were no brokered deposits at June 30, 2016 or December 31, 2015.

**Short-term Borrowing Arrangements.** The Company is a member of the FHLB and can borrow up to \$161 million from the FHLB secured by commercial and residential mortgage loans with carrying values totaling \$246 million. The Company is required to hold FHLB stock as a condition of membership. At June 30, 2016 and December 31, 2015, the Company held \$2,438,000 and \$2,380,000, respectively of FHLB stock which is recorded as a component of other assets. Based on the Company's stock holdings at June 30, 2016, the Company can borrow up to \$90.3 million. To borrow the \$161 million in available credit the Company would need to purchase \$1.9 million in additional FHLB stock. In addition to its FHLB borrowing line, the Company has unsecured short-term borrowing agreements with three of its correspondent banks in the amounts of \$20 million, \$11 million and \$10 million. There were no outstanding borrowings to the FHLB or the correspondent banks under these agreements at June 30, 2016 and December 31, 2015.

**Note Payable and Term Loan.** On October 24, 2013 the Company issued a \$3.0 million promissory note (the "Note") payable to an unrelated commercial bank. As originally issued, the Note provided for an interest rate of U.S. "Prime Rate" plus three-quarters percent per annum, 4.00% at December 31, 2014 and 2013, had a term of 18 months and subjected the Bank to several negative and affirmative covenants including, but not limited to providing timely financial information, maintaining specified levels of capital, restrictions on additional borrowings, and meeting or exceeding certain capital and asset quality ratios. The Note is secured by 100 shares of the Bank's stock representing the 100% of the Company's ownership interest in the Bank.

On July 28, 2014, the Company and the borrower modified the Note to (1) extend the maturity date to October 24, 2015, (2) increase the maximum principal amount to \$7.5 million and (3) permit the Company to borrow, repay and reborrow up to the maximum principal amount of the Note, among other things.



On October 1, 2015, the Company and the borrower further modified the Note to (1) extend the maturity date to October 1, 2016, (2) reduce the maximum principal amount to \$2.5 million and (3) change the interest rate to U.S. "Prime Rate" plus one-half percent per annum.

Concurrently, with entering into the second modification of the note on October 1, 2015, the Company entered into a \$5.0 million term loan (the "Term Loan"), which matures on October 1, 2018. The Term Loan requires quarterly principal payments of \$125,000 plus accrued interest. Both the Term Loan and the Note bear interest at a rate of the U.S. "Prime Rate" plus one-half percent per annum and are secured by 100 shares of Plumas Bank stock representing the Company's 100% ownership interest in Plumas Bank.

Under the Term Loan and the Note, the Bank is subject to several negative and affirmative covenants similar to the covenants under the original Note but in several cases less restrictive. The Bank was in compliance with all such covenants related to the Note and the Term Loan at June 30, 2016 and December 31, 2015. Interest expense related to the Note and the Term Loan for the six months ended June 30, 2016 and 2015 totaled \$76 thousand and \$55 thousand, respectively. The ending balance of the Note at December 31, 2014 was \$1,000,000. There was no balance outstanding on the Note at December 31, 2015 or June 30, 2016. On April 21, 2016 Plumas Bancorp made a \$2 million payment on the term loan. The payment was funded through a \$3 million dividend from Plumas Bank. The balance of the Term Loan was \$2,625,000 and \$4,875,000 at June 30, 2016 and December 31, 2015, respectively.

**Repurchase Agreements.** In 2011 the Bank introduced a new product for its larger business customers which use repurchase agreements as an alternative to interest-bearing deposits. The balance in this product at June 30, 2016 was \$3.9 million, a decrease of \$3.8 million from the December 31, 2015 balance of \$7.7 million. Interest paid on this product is similar to that which is paid on the Bank's premium money market account; however, these are not deposits and are not FDIC insured.

**Subordinated Debentures.** On April 15, 2013 the Company issued a \$7.5 million subordinated debenture ("subordinated debt"). The subordinated debt was issued to an unrelated third-party pursuant to a subordinated debenture purchase agreement, subordinated debenture note, and stock purchase warrant. On April 16, 2015 the Company paid off the subordinated debt. Interest expense related to the subordinated debt for the six months ended June 30, 2015 was \$219,000.

The subordinated debt had an interest rate of 7.5% per annum and a term of 8 years with no prepayment allowed during the first two years and was made in conjunction with an eight-year warrant to purchase up to 300,000 shares of the Bancorp's common stock, no par value at an exercise price, subject to anti-dilution adjustments, of \$5.25 per share. These items were partially offset by the repurchase of a portion of a warrant. In May of 2016 the Company repurchased a portion of the warrant, representing the right to purchase 150,000 shares of the registrant's common stock at a cost of \$0.9 million. The remaining warrant represents the right to purchase 150,000 shares of Plumas Bancorp common stock at an exercise price of \$5.25 per share.

**Junior Subordinated Deferrable Interest Debentures.** Plumas Statutory Trust I and II are business trust subsidiaries formed by the Company with capital of \$315,000 and \$164,000, respectively, for the sole purpose of issuing trust preferred securities fully and unconditionally guaranteed by the Company.

During 2002, Trust I issued 6,000 Floating Rate Capital Trust Pass-Through Securities ("Trust Preferred Securities"), with a liquidation value of \$1,000 per security, for gross proceeds of \$6,000,000. During 2005, Trust II issued 4,000 Trust Preferred Securities with a liquidation value of \$1,000 per security, for gross proceeds of \$4,000,000. The entire proceeds were invested by Trust I in the amount of \$6,186,000 and Trust II in the amount of \$4,124,000 in Floating Rate Junior Subordinated Deferrable Interest Debentures (the "Subordinated Debentures") issued by the Company, with identical maturity, repricing and payment terms as the Trust Preferred Securities. The Subordinated Debentures represent the sole assets of Trusts I and II.

Trust I's Subordinated Debentures mature on September 26, 2032, bear a current interest rate of 4.04% (based on 3-month LIBOR plus 3.40%), with repricing and payments due quarterly. Trust II's Subordinated Debentures mature on September 28, 2035, bear a current interest rate of 2.13% (based on 3-month LIBOR plus 1.48%), with repricing and payments due quarterly. The interest rate of the Trust Preferred Securities issued by Trust I adjust on each quarterly anniversary date to equal the 3-month LIBOR plus 3.40%. The Trust Preferred Securities issued by Trust II adjust on each quarterly anniversary date to equal the 3-month LIBOR plus 1.48%. Both Trusts I and II have the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default on the payment of interest on the Subordinated Debentures.

Interest expense recognized by the Company for the six months ended June 30, 2016 and 2015 related to the subordinated debentures was \$169,000 and \$150,000, respectively.

### **Capital Resources**

Shareholders' equity increased by \$3.9 million from \$42.5 million at December 31, 2015 to \$46.4 million at June 30, 2016. The \$3.9 million increase was related to earnings during the six month period of \$3.4 million, an increase in net unrealized gains on investment securities of \$1.2 million and an increase of \$0.2 million representing stock option activity. The items were partially offset by the repurchase of a portion of the warrant as described above.

It is the policy of the Company to periodically distribute excess retained earnings to the shareholders through the payment of cash dividends. Such dividends help promote shareholder value and capital adequacy by enhancing the marketability of the Company's stock. All authority to provide a return to the shareholders in the form of a cash or stock dividend or split rests with the Board of Directors. The Board will periodically, but on no regular schedule, review the appropriateness of a cash dividend payment. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. No common cash dividends were paid during the last seven years.

The Company is subject to various restrictions on the payment of dividends.

**Capital Standards.** The Company uses a variety of measures to evaluate its capital adequacy. Management reviews these capital measurements on a monthly basis and takes appropriate action to ensure that they are within established internal and external guidelines. The FDIC has promulgated risk-based capital guidelines for all state non-member banks such as the Bank. These guidelines establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures.

In July, 2013, the federal bank regulatory agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks. The phase-in period for the final rules began on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule. Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets. The final rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and require a minimum leverage ratio of 4.0%. The final rules also implement strict eligibility criteria for regulatory capital instruments.

The Board of Governors of the Federal Reserve System has adopted final amendments to the Small Bank Holding Company Policy Statement (Regulation Y, Appendix C) ( the “Policy Statement”) that, among other things, raised from \$500 million to \$1 billion the asset threshold to qualify for the Policy Statement. Plumas Bancorp qualifies for treatment under the Policy Statement and is no longer subject to consolidated capital rules at the bank holding company level.

The following table sets forth the Bank's actual capital amounts and ratios (dollar amounts in thousands):

|                                 | Actual   |        | Amount of Capital Required<br>To be<br>Well-Capitalized |       |  |        |
|---------------------------------|----------|--------|---|-------|--|--------|
|                                 |          |        | For Capital<br>Adequacy<br>Purposes                     |       | Under Prompt<br>Corrective<br>Provisions |        |
|                                 | Amount   | Ratio  | Amount  | Ratio | Amount                                   | Ratio  |
| <b>June 30, 2016</b>            |          |        |   |       |  |        |
| Common Equity Tier 1 Ratio      | \$56,709 | 12.0 % | \$21,209  | 4.5 % | \$30,635                                 | 6.5 %  |
| Tier 1 Leverage Ratio           | 56,709   | 9.5 %  | 23,859  | 4.0 % | 29,823                                   | 5.0 %  |
| Tier 1 Risk-Based Capital Ratio | 56,709   | 12.0 % | 28,278  | 6.0 % | 37,704                                   | 8.0 %  |
| Total Risk-Based Capital Ratio  | 62,609   | 13.3 % | 37,704  | 8.0 % | 47,130                                   | 10.0 % |
| <b>December 31, 2015</b>        |          |        |   |       |  |        |
| Common Equity Tier 1 Ratio      | \$56,300 | 12.7 % | \$19,908  | 4.5 % | \$28,756                                 | 6.5 %  |
| Tier 1 Leverage Ratio           | 56,300   | 9.4 %  | 23,999  | 4.0 % | 29,999                                   | 5.0 %  |
| Tier 1 Risk-Based Capital Ratio | 56,300   | 12.7 % | 26,544  | 6.0 % | 35,392                                   | 8.0 %  |
| Total Risk-Based Capital Ratio  | 61,839   | 14.0 % | 35,392  | 8.0 % | 44,240                                   | 10.0 % |

Management believes that Plumas Bank currently meets all its capital adequacy requirements.

The current and projected capital positions of the Bank and the impact of capital plans and long-term strategies are reviewed regularly by management. The Company policy is to maintain the Bank's ratios above the prescribed well-capitalized ratios at all times.

### **Off-Balance Sheet Arrangements**

**Loan Commitments.** In the normal course of business, there are various commitments outstanding to extend credits that are not reflected in the financial statements. Commitments to extend credit and letters of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Annual review of commercial credit lines, letters of credit and ongoing monitoring of outstanding balances reduces the risk of loss associated with these commitments. As of June 30, 2016, the Company had \$87.9 million in unfunded loan commitments and \$625 thousand in letters of credit. This compares to \$83.0 million in unfunded loan commitments and \$265 thousand in letters of credit at December 31, 2015. Of the \$87.9 million in unfunded loan commitments, \$50.2 million and \$37.7 million represented commitments to commercial and consumer customers, respectively. Of

the total unfunded commitments at June 30, 2016, \$48.2 million were secured by real estate, of which \$20.7 million was secured by commercial real estate and \$27.5 million was secured by residential real estate in the form of equity lines of credit. The commercial loan commitments not secured by real estate primarily represent business lines of credit, while the consumer loan commitments not secured by real estate primarily represent revolving credit card lines and overdraft protection lines. Since some of the commitments are expected to expire without being drawn upon the total commitment amounts do not necessarily represent future cash requirements.

**Operating Leases.** The Company leases two depository branches and four lending offices and two non-branch automated teller machine locations. Total rental expenses under all operating leases were \$152,000 and \$109,000 during the six months ended June 30, 2016 and 2015, respectively. The increase in rental expense in 2016 mostly relates to the rental of our Redding, California Branch. The expiration dates of the leases vary, with the first such lease expiring during 2016 and the last such lease expiring during 2020.

### **Liquidity**

The Company manages its liquidity to provide the ability to generate funds to support asset growth, meet deposit withdrawals (both anticipated and unanticipated), fund customers' borrowing needs, satisfy maturity of short-term borrowings and maintain reserve requirements. The Company's liquidity needs are managed using assets or liabilities, or both. On the asset side, in addition to cash and due from banks, the Company maintains an investment portfolio which includes unpledged U.S. Government-sponsored agency securities that are classified as available-for-sale. On the liability side, liquidity needs are managed by charging competitive offering rates on deposit products and the use of established lines of credit.

The Company is a member of the FHLB and can borrow up to \$161 million from the FHLB secured by commercial and residential mortgage loans with carrying values totaling \$246 million. See “Short-term Borrowing Arrangements” for additional information on our FHLB borrowing capacity. In addition to its FHLB borrowing line, the Company has unsecured short-term borrowing agreements with three of its correspondent banks in the amounts of \$20 million, \$11 million and \$10 million. There were no outstanding borrowings under the FHLB or the correspondent bank borrowing lines at June 30, 2016 or December 31, 2015.

Customer deposits are the Company’s primary source of funds. Total deposits were \$534.6 million at June 30, 2016, an increase of \$7.3 million from \$527.3 million at December 31, 2015. Deposits are held in various forms with varying maturities. The Company’s securities portfolio, Federal funds sold, FHLB advances, and cash and due from banks serve as the primary sources of liquidity, providing adequate funding for loans during periods of high loan demand. During periods of decreased lending, funds obtained from the maturing or sale of investments, loan payments, and new deposits are invested in short-term earning assets, such as cash held at the FRB, Federal funds sold and investment securities, to serve as a source of funding for future loan growth. Management believes that the Company’s available sources of funds, including borrowings, will provide adequate liquidity for its operations in the foreseeable future.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a smaller reporting company we are not required to provide the information required by this item.

### **ITEM 4. CONTROLS AND PROCEDURES**

The Company's Chief Executive Officer and Chief Financial Officer, based on their evaluation of the Company's disclosure controls and procedures as of the end of the Company's fiscal quarter ended June 30, 2016 (as defined in Exchange Act Rule 13a—15(e)), have concluded that the Company's disclosure controls and procedures are adequate and effective for purposes of Rule 13a—15(e) in timely alerting them to material information relating to the Company required to be included in the Company's filings with the SEC under the Securities Exchange Act of 1934.

There were no changes in internal control over financial reporting during the fiscal quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

## **PART II — OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

From time to time, the Company and/or its subsidiary are a party to claims and legal proceedings arising in the ordinary course of business. In the opinion of the Company's management, the amount of ultimate liability with respect to such proceedings will not have a material adverse effect on the financial condition or results of operations of the Company taken as a whole.

#### **Item 1A RISK FACTORS**

There have been no material changes to the principal risks that we believe are material to our business, results of operations and financial condition, from the risk factors previously disclosed in the 2015 Annual Report on Form 10-K. For a discussion on these risk factors, please see "Item 1A. Risk Factors" contained in the 2015 Annual Report



on Form 10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(a) None.

(b) None.

(c) None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

## ITEM 6. EXHIBITS

The following documents are included or incorporated by reference in this Quarterly Report on Form 10Q:

- 3.1 Articles of Incorporation as amended of Registrant included as exhibit 3.1 to the Registrant's Form S-4, File No. 333-84534, which is incorporated by reference herein.
- 3.2 Bylaws of Registrant as amended on March 16, 2011 included as exhibit 3.2 to the Registrant's Form 10-K for December 31, 2010, which is incorporated by this reference herein.
- 3.3 Amendment of the Articles of Incorporation of Registrant dated November 1, 2002, is included as exhibit 3.3 to the Registrant's 10-Q for September 30, 2005, which is incorporated by this reference herein.
- 3.4 Amendment of the Articles of Incorporation of Registrant dated August 17, 2005, is included as exhibit 3.4 to the Registrant's 10-Q for September 30, 2005, which is incorporated by this reference herein.
- 4 Specimen form of certificate for Plumas Bancorp included as exhibit 4 to the Registrant's Form S-4, File No. 333-84534, which is incorporated by reference herein.
- 10.1 Executive Salary Continuation Agreement of Andrew J. Ryback dated December 17, 2008, is included as exhibit 10.1 to the Registrant's 10-K for December 31, 2008, which is incorporated by this reference herein.
- 10.2 Split Dollar Agreement of Andrew J. Ryback dated August 23, 2005, is included as Exhibit 10.2 to the Registrant's 8-K filed on October 17, 2005, which is incorporated by this reference herein.
- 10.3 Subordinated Debenture dated April 15, 2013, is included as Exhibit 10.3 to the Registrant's 10-Q filed on May 10, 2013, which is incorporated by this reference herein.
- 10.4 Stock Purchase Warrant dated April 15, 2013, is included as Exhibit 10.4 to the Registrant's 10-Q filed on May 10, 2013, which is incorporated by this reference herein.
- 10.5 Subordinated Debenture Purchase Agreement dated April 15, 2013, is included as Exhibit 10.5 to the Registrant's 10-Q filed on November 7, 2013, which is incorporated by this reference herein.
- 10.6 Promissory Note Dated October 24, 2013, is included as Exhibit 10.6 to the Registrant's 10-Q filed on May 10, 2013, which is incorporated by this reference herein.
- 10.8 Director Retirement Agreement of John Flournoy dated March 21, 2007, is included as Exhibit 10.8 to Registrant's 10-Q for March 31, 2007, which is incorporated by this reference herein.
- 10.9 Amendment to Salary Continuation Agreement of Andrew J. Ryback dated April 1, 2016, is included as Exhibit 10.1 to the Registrant's 8-K filed on April 4, 2016, which is incorporated by this reference herein.
- 10.10

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Salary Continuation Agreement of Richard L. Belstock dated April 1, 2016, is included as Exhibit 10.2 to the Registrant's 8-K filed on April 4, 2016, which is incorporated by this reference herein.

- 10.11 Salary Continuation Agreement of Kerry D. Wilson dated April 1, 2016, is included as Exhibit 10.3 to the Registrant's 8-K filed on April 4, 2016, which is incorporated by this reference herein.
- 10.12 Salary Continuation Agreement of BJ North dated April 1, 2016, is included as Exhibit 10.4 to the Registrant's 8-K filed on April 4, 2016, which is incorporated by this reference herein.
- 10.18 Amended and Restated Director Retirement Agreement of Daniel E. West dated May 10, 2000, is included as Exhibit 10.18 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.19 Consulting Agreement of Daniel E. West dated May 10, 2000, is included as Exhibit 10.19 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.

- 10.21 Amended and Restated Director Retirement Agreement of Alvin G. Blickenstaff dated April 19, 2000, is included as Exhibit 10.21 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.22 Consulting Agreement of Alvin G. Blickenstaff dated May 8, 2000, is included as Exhibit 10.22 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.24 Amended and Restated Director Retirement Agreement of Gerald W. Fletcher dated May 10, 2000, is included as Exhibit 10.24 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.25 Consulting Agreement of Gerald W. Fletcher dated May 10, 2000, is included as Exhibit 10.25 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.27 Amended and Restated Director Retirement Agreement of Arthur C. Grohs dated May 9, 2000, is included as Exhibit 10.27 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.28 Consulting Agreement of Arthur C. Grohs dated May 9, 2000, is included as Exhibit 10.28 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.33 Amended and Restated Director Retirement Agreement of Terrance J. Reeson dated April 19, 2000, is included as Exhibit 10.33 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.34 Consulting Agreement of Terrance J. Reeson dated May 10, 2000, is included as Exhibit 10.34 to the Registrant's 10-QSB for June 30, 2002, which is incorporated by this reference herein.
- 10.41 Form of Indemnification Agreement (Plumas Bancorp) is included as Exhibit 10.41 to the Registrant's 10-Q for March 31, 2009, which is incorporated by this reference herein.
- 10.42 Form of Indemnification Agreement (Plumas Bank) is included as Exhibit 10.42 to the Registrant's 10-Q for March 31, 2009, which is incorporated by this reference herein.
- 10.43 Plumas Bank 401(k) Profit Sharing Plan as amended is included as exhibit 99.1 of the Form S-8 filed February 14, 2003, File No. 333-103229, which is incorporated by this reference herein.
- 10.47 2013 Stock Option Plan is included as exhibit 99.1 of the Form S-8 filed September 12, 2013, which is incorporated by this reference herein.
- 10.48 Specimen Form of Incentive Stock Option Agreement under the 2013 Stock Option Plan is included as exhibit 99.2 of the Form S-8 filed September 12, 2013, which is incorporated by this reference herein.
- 10.49 Specimen Form of Nonqualified Stock Option Agreement under the 2013 Stock Option Plan is included as exhibit 99.3 of the Form S-8 filed September 12, 2013, which is incorporated by this reference herein.
- 10.51 First Amendment to Split Dollar Agreement of Andrew J. Ryback, is included as exhibit 10.51 to the Registrant's 10-K for December 31, 2008, which is incorporated by this reference herein.

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10.64 First Amendment to the Plumas Bank Amended and Restated Director Retirement Agreement for Alvin Blickenstaff adopted on September 19, 2007, is included as Exhibit 10.64 to the Registrant's 8-K filed on September 25, 2007, which is incorporated by this reference herein.

10.65 First Amendment to the Plumas Bank Amended and Restated Director Retirement Agreement for Arthur C. Grohs adopted on September 19, 2007, is included as Exhibit 10.65 to the Registrant's 8-K filed on September 25, 2007, which is incorporated by this reference herein.

- 10.66 Director Retirement Agreement of Robert McClintock, is included as Exhibit 10.66 to the Registrant's 10-K filed on March 23, 2012, which is incorporated by this reference herein.
- 10.67 First Amendment to the Plumas Bank Amended and Restated Director Retirement Agreement for Terrance J. Reeson adopted on September 19, 2007, is included as Exhibit 10.67 to the Registrant's 8-K filed on September 25, 2007, which is incorporated by this reference herein.
- 10.69 First Amendment to the Plumas Bank Amended and Restated Director Retirement Agreement for Daniel E. West adopted on September 19, 2007, is included as Exhibit 10.69 to the Registrant's 8-K filed on September 25, 2007, which is incorporated by this reference herein.
- 10.70 First Amendment to the Plumas Bank Amended and Restated Director Retirement Agreement for Gerald W. Fletcher adopted on October 9, 2007, is included as Exhibit 10.70 to the Registrant's 10-Q for September 30, 2007, which is incorporated by this reference herein.
- 11 Computation of per share earnings appears in the attached 10-Q under Plumas Bancorp and Subsidiary Notes to Condensed Consolidated Financial Statements as Footnote 6 – Earnings Per Share.
- 31.1\* Rule 13a-14(a) [Section 302] Certification of Principal Financial Officer dated August 3, 2016.
- 31.2\* Rule 13a-14(a) [Section 302] Certification of Principal Executive Officer dated August 3, 2016.
- 32.1\* Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 dated August 3, 2016.
- 32.2\* Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 dated August 3, 2016.
- 101.INS\* XBRL Instance Document.
- 101.SCH\* XBRL Taxonomy Schema.
- 101.CAL\* XBRL Taxonomy Calculation Linkbase.
- 101.DEF\* XBRL Taxonomy Definition Linkbase.
- 101.LAB\* XBRL Taxonomy Label Linkbase.
- 101.PRE\* XBRL Taxonomy Presentation Linkbase.
- \* Filed herewith

## SIGNATURES

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

### **PLUMAS BANCORP**

(Registrant)

Date: August 3, 2016

/s/ Richard L. Belstock  
Richard L. Belstock  
*Chief Financial Officer*

/s/ Andrew J. Ryback  
Andrew J. Ryback  
*Director, President and Chief Executive Officer*