UNITED SECURITY BANCSHARES
Form 10-Q
August 08, 2014
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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2014
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number: 000-32897

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

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

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).
Large accelerated filer o Accelerated filer o Non-accelerated filer o Small reporting company x

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

Aggregate market value of the Common Stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter - June 30, 2014: $59,326,341

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

Common Stock, no par value
(Title of Class)

Shares outstanding as of July 31, 2014: 15,097,282

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PART I. Financial Information

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets – (unaudited)
June 30, 2014 and December 31, 2013

(in thousands except shares)	June 30, 2014	December 31, 2013
Assets		
Cash and due from banks	$22,014	$20,193
Cash and due from Federal Reserve Bank	98,685	115,019
Cash and cash equivalents	120,699	135,212
Interest-bearing deposits in other banks	1,518	1,515
Investment securities available for sale (at fair value)	51,258	43,616
Loans and leases	422,927	395,317
Unearned fees and unamortized loan origination costs	(759)	(304)
Allowance for credit losses	(11,049)	(10,988)
Net loans and leases	411,119	384,025
Accrued interest receivable	1,827	1,644
Premises and equipment – net	11,965	12,122
Other real estate owned	14,100	13,946
Intangible assets	—	62
Goodwill	4,488	4,488
Cash surrender value of life insurance	17,458	17,203
Investment in limited partnerships	944	4,534
Deferred income taxes - net	11,667	11,630
Other assets	5,767	5,932
Total assets	$652,810	$635,929
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$227,092	$214,317
Interest bearing	328,973	328,172
Total deposits	556,065	542,489
Accrued interest payable	39	44
Accounts payable and other liabilities	7,087	5,728
Junior subordinated debentures (at fair value)	10,082	11,125
Total liabilities	573,273	559,386
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 15,097,282 issued and outstanding at June 30, 2014, and 14,799,888 at December 31, 2013	47,478	45,778
Retained earnings	32,155	30,884
Accumulated other comprehensive loss	(96)	(119)
Total shareholders' equity	79,537	76,543
Total liabilities and shareholders' equity	$652,810	$635,929

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

	Quarter Ended June 30,		Six Months Ended June 30,	
(In thousands except shares and EPS)	2014	2013	2014	2013
Interest Income:				
Loans, including fees	$5,940	$5,554	$11,415	$11,020
Investment securities – AFS – taxable	233	140	461	338
Interest on deposits in FRB	64	70	147	135
Interest on deposits in other banks	1	2	3	4
Total interest income	6,238	5,766	12,026	11,497
Interest Expense:				
Interest on deposits	259	331	521	742
Interest on other borrowings	63	93	124	153
Total interest expense	322	424	645	895
Net Interest Income Before Provision for Credit Losses	5,916	5,342	11,381	10,602
(Recovery) Provision for Credit Losses	(93)	39	(140)	30
Net Interest Income	6,009	5,303	11,521	10,572
Noninterest Income:				
Customer service fees	888	902	1,682	1,681
Increase in cash surrender value of bank-owned life insurance	128	140	255	277
(Gain) loss on fair value of financial liability	216	(103)	(129)	(660)
Gain on sale of investment in limited partnership	691	—	691	—
Gain on sale of fixed asset	25	—	25	—
Other	157	168	298	328
Total noninterest income	2,105	1,107	2,822	1,626
Noninterest Expense:				
Salaries and employee benefits	2,279	2,113	4,805	4,474
Occupancy expense	956	883	1,829	1,788
Data processing	28	33	69	93
Professional fees	327	375	507	820
Regulatory assessments	239	339	472	698
Director fees	61	59	117	117
Amortization of intangibles	15	46	62	93
Correspondent bank service charges	30	81	59	157
Loss on California tax credit partnership	24	32	47	65
Net cost (gain) on operation and sale of OREO	84	(336)	364	(1,218)
Other	701	529	1,207	1,140
Total noninterest expense	4,744	4,154	9,538	8,227
Income Before Provision for Taxes	3,370	2,256	4,805	3,971
Provision for Taxes on Income	1,323	859	1,849	1,499
Net Income	$2,047	$1,397	$2,956	$2,472
Net Income per common share				
Basic	$0.14	$0.09	$0.20	$0.16
Diluted	$0.14	$0.09	$0.20	$0.16

Shares on which net income per common shares were based				
Basic	15,097,282	15,095,299	15,097,282	15,093,567
Diluted	15,106,620	15,096,979	15,105,488	15,097,626

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

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net Income	$2,047	$1,397	$2,956	$2,472
Unrealized holdings gains (losses) on securities	57	(305)	8	(415)
Unrealized gains on unrecognized post retirement costs	15	21	31	40
Other comprehensive income (loss,) before tax	72	(284)	39	(375)
Tax (benefit) expense related to securities	(23)	122	(3)	166
Tax expense related to unrecognized post retirement costs	(6)	(8)	(13)	(17)
Total other comprehensive income (loss)	43	(170)	23	(226)
Comprehensive income	$2,090	$1,227	$2,979	$2,246

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

	Common stock				
(In thousands except shares)	Number of Shares	Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance December 31, 2012	14,217,303	$43,173	$26,179	$ 89	$69,441
Other comprehensive loss				(226)	(226)
Common stock dividends	285,770	1,223	(1,223)		0
Common stock issuance	5,202	12			12
Stock-based compensation expense		9			9
Net Income			2,472		2,472
Balance June 30, 2013	14,508,275	$44,417	$27,428	$ (137)	$71,708
Other comprehensive loss				18	18
Common stock dividends	291,613	1,341	(1,341)		
Stock-based compensation expense		20			20
Net Income			4,797		4,797
Balance December 31, 2013	14,799,888	$45,778	$30,884	$ (119)	$76,543
Other comprehensive loss				23	23
Common stock dividends	297,394	1,685	(1,685)		0
Stock-based compensation expense		15			15
Net Income			2,956		2,956
Balance June 30, 2014	15,097,282	$47,478	$32,155	$ (96)	$79,537

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

	Six Months Ended June 30,	
(In thousands)	2014	2013
Cash Flows From Operating Activities:		
Net Income	$2,956	$2,472
Adjustments to reconcile net income:to cash provided by operating activities:		
(Benefit) provision for credit losses	(140)	30
Depreciation and amortization	667	620
Amortization of investment securities	120	14
Accretion of investment securities	(18)	(34)
(Increase) decrease in accrued interest receivable	(183)	158
Decrease in accrued interest payable	(5)	(11)
(Decrease) increase in accounts payable and accrued liabilities	(1,172)	89
Increase (decrease) in unearned fees	455	(18)
Increase in income taxes payable	1,898	1,771
Stock-based compensation expense	15	9
(Benefits) provision for deferred income taxes	(53)	272
Gain on sale of other real estate owned	(107)	(1,949)
Impairment loss on other real estate owned	—	118
Increase in surrender value of life insurance	(255)	(294)
Loss on fair value option of financial liabilities	129	660
Loss on tax credit limited partnership interest	47	65
Amortization of CDI	62	93
Gain on sale of investment in limited partnership	(691)	—
Gain on sale of premises and equipment	(25)	—
Net decrease in other assets	(192)	(221)
Net cash provided by operating activities	3,508	3,844
Cash Flows From Investing Activities:		
Net increase in interest-bearing deposits with banks	(3)	(4)
Redemption of correspondent bank stock	—	433
Purchase of correspondent bank stock	(97)	—
Purchases of available-for-sale securities	(10,192)	—
Maturities and calls of available-for-sale securities	—	3,600
Principal payments of available-for-sale securities	2,456	2,322
Net increase in loans	(25,473)	(3,750)
Cash proceeds from sales of other real estate owned	1,017	6,651
Investment in limited partnership	(70)	—
Cash proceeds from sale of investment in limited partnership	1,250	—
Capital expenditures of premises and equipment	(485)	(280)
Net cash (used in) provided by investing activities	(31,597)	8,972
Cash Flows From Financing Activities:		
Net increase (decrease) in demand deposits and savings accounts	12,422	(10,786)
Net increase (decrease) in certificates of deposit	1,154	(5,400)

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Proceeds from exercise of stock options	—	12
Net cash provided by (used in) financing activities	13,576	(16,174)
Net decrease in cash and cash equivalents	(14,513)	(3,358)
Cash and cash equivalents at beginning of period	135,212	141,627
Cash and cash equivalents at end of period	$120,699	$138,269

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

1. Organization and Summary of Significant Accounting and Reporting Policies

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

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2013 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Recently Issued Accounting Standards:

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-01 Accounting for Investments in Qualified Affordable Housing Projects. This ASU provides "guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit." It allows the proportional amortization method to be used by a reporting entity if certain conditions are met. The ASU also defines when a qualified affordable housing project through a limited liability entity should be tested for impairment. If a qualified affordable housing project does not meet the conditions for using the proportional amortization method, the investment should be accounted for using an equity method investment or a cost method investment. The ASU is effective for fiscal years beginning after December 15, 2014, and interim periods therein.

In November 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-04 Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in the ASU clarify when an in substance repossession or foreclosure occurs - that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The new ASU requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15 2014.

In February 2013, The Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, to improve the transparency of reporting reclassifications out of accumulated other comprehensive income. ASU 2013-02 requires an organization to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income–but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for reporting periods beginning after December 15, 2012. The amounts reclassified out of net income were not significant and this ASU did not have a significant impact on the Company’s financial statements.

In January 2013, the FASB issued ASU No. 2013-01 Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, which clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. It further clarifies that the scope of ASU No. 2011-11 applies to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in FASB Accounting Standards Codification® or subject to a master netting arrangement or similar agreement. Both ASU 2011-11 and ASU 2013-1 are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company adopted these ASUs during the first quarter of 2013 and they did not have a material impact on its financial statements.

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2. Investment Securities

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of June 30, 2014 and December 31, 2013:

(In thousands) June 30, 2014 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$13,130	$415	$—	$13,545
U.S. Government collateralized mortgage obligations	33,593	399	(80)	33,912
Mutual Funds	4,000	—	(199)	3,801
Total securities available for sale	$50,723	$814	$(279)	$51,258
December 31, 2013 Securities available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	$14,060	$441	$—	$14,501
U.S. Government collateralized mortgage obligations	25,029	434	(78)	25,385
Mutual Funds	4,000	—	(270)	3,730
Total securities available for sale	$43,089	$875	$(348)	$43,616

The amortized cost and fair value of securities available for sale at June 30, 2014, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

	June 30, 2014	
(In thousands)	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	$4,000	$3,801
Due after one year through five years	49	51
Due after five years through ten years	—	—
Due after ten years	13,081	13,494
Collateralized mortgage obligations	33,593	33,912
	$50,723	$51,258

There were no realized gains or losses on sale of available-for-sale securities for the three and six month periods ended June 30, 2014 and June 30, 2013. There were no other-than-temporary impairment losses for the three and six month periods ended June 30, 2014 and June 30, 2013.

At June 30, 2014, available-for-sale securities with an amortized cost of approximately $22,333,000 (fair value of $23,035,000) were pledged as collateral for FHLB borrowings and public funds balances.

The Company had no held-to-maturity or trading securities at June 30, 2014 or December 31, 2013.

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

The following summarizes temporarily impaired investment securities:

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(In thousands)	Less than 12 Months		12 Months or More		Total	
June 30, 2014 Securities available for sale:	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
U.S. Government agencies	$—	$—	$—	$—	$—	$—
U.S. Government agency collateral mortgage obligations	10,112	(80)	—	—	10,112	(80)
Mutual Funds	—	—	3,801	(199)	3,801	(199)
Total impaired securities	$10,112	$(80)	$3,801	$(199)	$13,913	$(279)
December 31, 2013 Securities available for sale:						
U.S. Government agencies	$—	$—	$—	$—	$—	$—
U.S. Government agency collateral mortgage obligations	11,069	(78)	—	—	11,069	(78)
Mutual Funds	—	—	3,730	(270)	3,730	(270)
Total impaired securities	$11,069	$(78)	$3,730	$(270)	$14,799	$(348)

Temporarily impaired securities at June 30, 2014, were comprised of five U.S. Government sponsored entities & agencies collateralized by mortgage obligations and one mutual fund.

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

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

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

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

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collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At June 30, 2014, the decline in market value of the impaired securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities and it is not more likely than not that it will be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at June 30, 2014.

3. Loans and Leases

Loans are comprised of the following:

(In thousands)	June 30, 2014	December 31, 2013
Commercial and business loans	$64,736	$68,460
Government program loans	2,121	2,226
Total commercial and industrial	66,857	70,686
Real estate – mortgage:		
Commercial real estate	153,702	143,919
Residential mortgages	48,790	52,036
Home Improvement and Home Equity loans	1,231	1,410
Total real estate mortgage	203,723	197,365
RE construction and development	111,706	87,004
Agricultural	31,477	30,932
Installment	9,164	9,330
Total Loans	$422,927	$395,317

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

Commercial and industrial loans represent 15.8% of total loans at June 30, 2014 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 48.2% of total loans at June 30, 2014, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings, shopping centers; apartments and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

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

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

Real estate construction and development loans, representing 26.4% of total loans at June 30, 2014, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 7.4% of total loans at June 30, 2014 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 2.2% of total loans at June 30, 2014 and generally consist of loans to individuals for household, family and other personal expenditures such as credit cards, automobiles or other consumer items.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At June 30, 2014 and December 31, 2013, these financial instruments include commitments to extend credit of $113,770,000 and $63,271,000, respectively, and standby letters of credit of $3,383,000 and $2,001,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

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

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

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

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Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. The following is a summary of delinquent loans at June 30, 2014 (in thousands):

June 30, 2014	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$595	$—	$99	$694	$64,042	$64,736	$—
Government Program Loans	—	—	—	—	2,121	2,121	—
Total Commercial and Industrial	595	—	99	694	66,163	66,857	—
Commercial Real Estate Loans	460	447	5,248	6,155	147,547	153,702	—
Residential Mortgages	—	247	97	344	48,446	48,790	—
Home Improvement and Home Equity Loans	—	—	—	—	1,231	1,231	—
Total Real Estate Mortgage	460	694	5,345	6,499	197,224	203,723	—
RE Construction and Development Loans	—	—	—	—	111,706	111,706	—
Agricultural Loans	—	—	—	—	31,477	31,477	—
Consumer Loans	74	—	—	74	8,847	8,921	—
Overdraft protection Lines	—	—	—	—	100	100	—
Overdrafts	—	—	—	—	143	143	—
Total Installment	74	—	—	74	9,090	9,164	—
Total Loans	$1,129	$694	$5,444	$7,267	$415,660	$422,927	$—

The following is a summary of delinquent loans at December 31, 2013 (in thousands):

December 31, 2013	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	$—	$94	$—	$94	$68,366	$68,460	$—
Government Program Loans	—	—	—	—	2,226	2,226	—
Total Commercial and Industrial	—	94	—	94	70,592	70,686	—
Commercial Real Estate Loans	1,991	—	6,866	8,857	135,062	143,919	—
Residential Mortgages	—	614	359	973	51,063	52,036	—
Home Improvement and Home Equity Loans	96	—	—	96	1,314	1,410	—

Total Real Estate Mortgage	2,087	614	7,225	9,926	187,439	197,365	—
RE Construction and Development Loans	—	—	220	220	86,784	87,004	—
Agricultural Loans	—	—	—	—	30,932	30,932	—
Consumer Loans	—	—	—	—	9,086	9,086	—
Overdraft protection Lines	—	—	—	—	87	87	—
Overdrafts	—	—	—	—	157	157	—
Total Installment	—	—	—	—	9,330	9,330	—
Total Loans	$2,087	$708	$7,445	$10,240	$385,077	$395,317	$—

Nonaccrual Loans

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

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

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

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

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

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

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

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

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

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

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

Nonaccrual loans totaled $9,549,000 and $12,341,000 at June 30, 2014 and December 31, 2013, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at June 30, 2014 or December 31, 2013.

The following is a summary of nonaccrual loan balances at June 30, 2014 and December 31, 2013 (in thousands).

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	June 30, 2014	December 31, 2013
Commercial and Business Loans	$143	$—
Government Program Loans	—	—
Total Commercial and Industrial	143	—
Commercial Real Estate Loans	8,112	10,188
Residential Mortgages	1,294	1,685
Home Improvement and Home Equity Loans	—	—
Total Real Estate Mortgage	9,406	11,873
RE Construction and Development Loans	—	468
Agricultural Loans	—	—
Consumer Loans	—	—
Overdraft protection Lines	—	—
Overdrafts	—	—
Total Installment	—	—
Total Loans	$9,549	$12,341

Impaired Loans

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

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

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

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

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

- For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable.

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

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

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

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

The following is a summary of impaired loans at, and for the six months ended June 30, 2014 (in thousands).

June 30, 2014	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	$612	$565	$50	$615	$27	$710	$22
Government Program Loans	539	539	—	539	—	269	15
Total Commercial and Industrial	1,151	1,104	50	1,154	27	979	37
Commercial Real Estate Loans	8,112	6,703	1,410	8,113	467	8,335	126
Residential Mortgages	4,633	1,399	3,245	4,644	231	4,785	102
Home Improvement and Home Equity Loans	—	—	—	—	—	—	—
Total Real Estate Mortgage	12,745	8,102	4,655	12,757	698	13,120	228
RE Construction and Development Loans	490	491	—	491	—	691	15
Agricultural Loans	38	38	—	38	—	40	5
Consumer Loans	46		46	46	3	47	2
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	46	—	46	46	3	47	2
	$14,470	$9,735	$4,751	$14,486	$728	$14,877	$287

Total Impaired
Loans

(1) The recorded investment in loans includes accrued interest receivable of $16,000.

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The following is a summary of impaired loans at, and for the year ended, December 31, 2013 (in thousands).

December 31, 2013	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	$675	$275	$402	$677	$9	$831	$52
Government Program Loans	—	—	—	—	—	35	—
Total Commercial and Industrial	675	275	402	677	9	866	52
Commercial Real Estate Loans	10,188	8,721	1,468	10,189	415	10,671	232
Residential Mortgages	5,375	1,794	3,590	5,384	338	6,139	211
Home Improvement and Home Equity Loans	—	—	—	—	—	13	—
Total Real Estate Mortgage	15,563	10,515	5,058	15,573	753	16,823	443
RE Construction and Development Loans	1,772	1,789	—	1,789	—	2,266	60
Agricultural Loans	44	45	—	45	—	84	10
Consumer Loans	48	48	—	48	—	72	4
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	48	48	—	48	—	72	4
Total Impaired Loans	$18,102	$12,672	$5,460	$18,132	$762	$20,111	$569

(1) The recorded investment in loans includes accrued interest receivable of $45,000.

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

The average recorded investment in impaired loans for the quarter ended June 30, 2014 and 2013 was $15,073,000 and $21,542,000, respectively. Interest income recognized on impaired loans for the quarters ended June 30, 2014 and 2013 was approximately $132,000 and $121,000, respectively.

The average recorded investment in impaired loans for the six months ended June 30, 2014 and 2013 was $14,877,000 and $20,310,000, respectively. Interest income recognized on impaired loans for the six months ended June 30, 2014 and 2013 was approximately $287,000 and $217,000, respectively.

Troubled Debt Restructurings

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

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

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

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

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

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

The following tables illustrates TDR activity for the periods indicated:

	Three Months Ended June 30, 2014				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	1	$ 50	$ 49	1	$ —
Government Program Loans	1	544	539	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Total Loans	2	$ 594	$ 588	1	$ —

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	Six Months Ended June 30, 2014				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	1	$50	$49	1	$—
Government Program Loans	1	544	539	1	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	2	495
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	2	394
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Total Loans	2	$594	$588	6	$889

	Three Months Ended June 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	$—	$—	—	$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	1	44	44	—	—
RE Construction and Development Loans	12	793	793	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Total Loans	13	$837	$837	—	$—

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	Six Months Ended June 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	$—	$—	—	$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	1	106
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	18	1,045	1,045	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Total Loans	18	$1,045	$1,045	1	$106

The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At June 30, 2014, the Company had 27 restructured loans totaling $7,627,000 as compared to 35 restructured loans totaling $9,059,000 at December 31, 2013.

The following tables summarize TDR activity by loan category for the six months ended June 30, 2014 and June 30, 2013.

Six Months Ended June 30, 2014	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Total
Beginning balance	$675	$1,468	$5,273	$—	$ 1,551	$44	$48	$9,059
Defaults	—	—	(495)	—	(394)	—	—	(889)
Additions	588	—	—	—	—	—	—	588
Principal reductions	(156)	(58)	(242)	—	(667)	(6)	(2)	(1,131)
Ending balance	$1,107	$1,410	$4,536	$—	$ 490	$38	$46	$7,627
Allowance for loan loss	$27	$467	$231	$—	$ —	$—	$3	$728

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Six Months Ended June 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Total
Beginning balance	$990	$5,395	$7,289	$10	$ 2,860	$191	$38	$16,773
Defaults	—	(106)	—	—	—	—	—	(106)
Additions	—	—	—	44	1,361	—	—	1,405
Principal reductions	(178)	(1,074)	(506)	(10)	(1,810)	(140)	(38)	(3,756)
Ending balance	$812	$4,215	$6,783	$44	$ 2,411	$51	$—	$14,316
Allowance for loan loss	$14	$380	$139	$2	$ —	$—	$—	$535

The following tables summarize TDR activity by loan category for the quarters ended June 30, 2014 and June 30, 2013.

Three months ended June 30, 2014	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	$660	$1,445	$4,813	$—	$ 885	$41	$47	$—	$7,891
Defaults	—	—	—	—	—	—	—	—	—
Additions	588	—	—	—	—	—	—	—	588
Principal reductions	(141)	(35)	(277)	—	(395)	(3)	(1)	—	(852)
Ending balance	$1,107	$1,410	$4,536	$—	$ 490	$38	$46	$—	$7,627
Allowance for loan loss	$27	$467	$231	$0	$ —	$—	$3	$—	$728

Three months ended June 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	$877	$4,258	$6,901	$9	$ 2,661	$190	$38	$—	$14,934
Defaults	—	—	—	—	—	—	—	—	—
Additions	—	—	—	44	793	—	—	—	837
Principal reductions	(65)	(43)	(118)	(9)	(1,043)	(139)	(38)	—	(1,455)

Ending balance	$812	$4,215	$6,783	$44	$ 2,411	$51	$—	$—	$14,316
Allowance for loan loss	$14	$380	$139	$2	$ —	$—	$—	$—	$535

Credit Quality Indicators

As part of its credit monitoring program, the Company utilizes a risk rating system which quantifies the risk the Company estimates it has assumed during the life of a loan. The system rates the strength of the borrower and the facility or transaction, and is designed to provide a program for risk management and early detection of problems.

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For each new credit approval, credit extension, renewal, or modification of existing credit facilities, the Company assigns risk ratings utilizing the rating scale identified in this policy. In addition, on an on-going basis, loans and credit facilities are reviewed for internal and external influences impacting the credit facility that would warrant a change in the risk rating. Each loan credit facility is to be given a risk rating that takes into account factors that materially affect credit quality.

When assigning risk ratings, the Company evaluates two risk rating approaches, a facility rating and a borrower rating as follows:

Facility Rating:

The facility rating is determined by the analysis of positive and negative factors that may indicate that the quality of a particular loan or credit arrangement requires that it be rated differently from the risk rating assigned to the borrower. The Company assesses the risk impact of these factors:

Collateral - The rating may be affected by the type and quality of the collateral, the degree of coverage, the economic life of the collateral, liquidation value and the Company's ability to dispose of the collateral.

Guarantees - The value of third party support arrangements varies widely. Unconditional guaranties from persons with demonstrable ability to perform are more substantial than that of closely related persons to the borrower who offer only modest support.

Unusual Terms - Credit may be extended on terms that subject the Company to a higher level of risk than indicated in the rating of the borrower.

Borrower Rating:

The borrower rating is a measure of loss possibility based on the historical, current and anticipated financial characteristics of the borrower in the current risk environment. To determine the rating, the Company considers at least the following factors:

- Quality of management
- Liquidity
- Leverage/capitalization
- Profit margins/earnings trend
- Adequacy of financial records
- Alternative funding sources
- Geographic risk
- Industry risk
- Cash flow risk
- Accounting practices
- Asset protection
- Extraordinary risks

The Company assigns risk ratings to loans other than consumer loans and other homogeneous loan pools based on the following scale. The risk ratings are used when determining borrower ratings as well as facility ratings. When the borrower rating and the facility ratings differ, the lowest rating applied is:

- Grades 1 and 2 – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the borrower's strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.

- Grade 3 – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower's balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.

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- Grades 4 and 5 – These include “pass” grade loans to borrowers of acceptable credit quality and risk. The borrower’s balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years, however recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully comply with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are “leveraged” or on management’s “watch list.” While still considered pass loans (loans given a grade 5), the borrower’s financial condition, cash flow or operations evidence more than average risk and short term weaknesses, these loans warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect credit weakness trends that weaken or inadequately protect the Company’s credit position. Loans with a grade rating of 5 are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.

- Grade 6 – This grade includes “special mention” loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company’s credit position at some future date. Special mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in special mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.

- Grade 7 – This grade includes “substandard” loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt. Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.

- Grade 8 - This grade includes “doubtful” loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

- Grade 9 - This grade includes loans classified “loss” which are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off the asset even though partial recovery may be achieved in the future.

The Company did not carry any loans graded as loss at June 30, 2014 or December 31, 2013.

The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for June 30, 2014 and December 31, 2013:

June 30, 2014	Commercial and Industrial	Commercial RE	RE Construction and Development	Agricultural	Total

(000's)					
Grades 1 and 2	$373	$—	$—	$—	$373
Grade 3	14	5,215	795	—	6,024
Grades 4 and 5 – pass	64,723	137,388	91,764	31,477	325,352
Grade 6 – special mention	342	1,104	—	—	1,446
Grade 7 – substandard	1,405	9,995	19,147	—	30,547
Grade 8 – doubtful	—	—	—	—	—
Total	$66,857	$153,702	$111,706	$31,477	$363,742

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December 31, 2013 (000's)	Commercial and Industrial	Commercial RE	RE Construction and Development	Agricultural	Total
Grades 1 and 2	$355	$—	$—	$70	$425
Grade 3	44	5,287	816	—	6,147
Grades 4 and 5 – pass	69,070	127,189	66,048	30,862	293,169
Grade 6 – special mention	590	—	—	—	590
Grade 7 – substandard	627	11,443	20,140	—	32,210
Grade 8 – doubtful	—	—	—	—	—
Total	$70,686	$143,919	$87,004	$30,932	$332,541

The Company follows consistent underwriting standards outlined in its loan policy for consumer and other homogeneous loans but, does not specifically assign a risk rating when these loans are originated. Consumer loans are monitored for credit risk and are considered “pass” loans until some issue or event requires that the credit be downgraded to special mention or worse.

The following tables summarize the credit risk ratings for consumer related loans and other homogeneous loans for June 30, 2014 and December 31, 2013:

	June 30, 2014				December 31, 2013			
(000's)	Residential Mortgages	Home Improvement and Home Equity	Installment	Total	Residential Mortgages	Home Improvement and Home Equity	Installment	Total
Not graded	$27,835	$1,200	$7,599	$36,634	$29,063	$1,378	$7,862	$38,303
Pass	18,028	—	935	18,963	19,320	—	1,468	20,788
Special Mention	—	31	—	31	1,204	32	—	1,236
Substandard	2,927	—	630	3,557	2,449	—	—	2,449
Total	$48,790	$1,231	$9,164	$59,185	$52,036	$1,410	$9,330	$62,776

Allowance for Loan Losses

The Company analyzes risk characteristics inherent in each loan portfolio segment as part of the quarterly review of the adequacy of the allowance for loan losses. The following summarizes some of the key risk characteristics for the eleven segments of the loan portfolio (Consumer loans include three segments):

Commercial and business loans – Commercial loans are subject to the effects of economic cycles and tend to exhibit increased risk as economic conditions deteriorate, or if the economic downturn is prolonged. The Company considers this segment to be one of higher risk given the size of individual loans and the balances in the overall portfolio.

Government program loans – This is a relatively a small part of the Company’s loan portfolio, but has historically had a high percentage of loans that have migrated from pass to substandard given there vulnerability to economic cycles.

Commercial real estate loans – This segment is considered to have more risk in part because of the vulnerability of commercial businesses to economic cycles as well as the exposure to fluctuations in real estate prices because most of these loans are secured by real estate. Losses in this segment have however been historically low because most of the loans are real estate secured, and the bank maintains appropriate loan-to-value ratios.

Residential mortgages – This segment is considered to have low risk factors both from the Company and peer statistics. These loans are secured by first deeds of trust. The losses experienced over the past twelve quarters are isolated to approximately seven loans and are generally the result of short sales.

Home improvement and home equity loans – Because of their junior lien position, these loans have an inherently higher risk level. Because residential real estate has been severely distressed in the recent past, the anticipated risk for this loan segment has increased.

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Real estate construction and development loans –In a normal economy, this segment of loans is considered to have a higher risk profile due to construction and market value issues in conjunction with normal credit risks. Although residential real estate markets have improved, they are still distressed on a historical basis, and therefore carry higher risk.

Agricultural loans – This segment is considered to have risks associated with weather, insects, and marketing issues. In addition, concentrations in certain crops or certain agricultural areas can increase risk.

Installment loans (Includes consumer loans, overdrafts, and overdraft protection lines) – This segment is higher risk because many of the loans are unsecured.

The following summarizes the activity in the allowance for credit losses by loan category for the six months ended June 30, 2014 and 2013.

Six Months Ended June 30, 2014	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$2,340	$1,862	$ 5,533	$ 583	$275	$—	$ 395	$10,988
Provision for credit losses	(1,026)	(52)	758	(92)	(23)	(46)	341	(140)
Charge-offs	(90)	(131)	(60)	—	—	—	(6)	(287)
Recoveries	172	9	222	3	36	46	—	488
Net recoveries	82	(122)	162	3	36	46	(6)	201
Ending balance	$1,396	$1,688	$ 6,453	$ 494	$288	$—	$ 730	$11,049
Period-end amount allocated to:								
Loans individually evaluated for impairment	27	698	—	—	3	—	—	728
Loans collectively evaluated for impairment	1,369	990	6,453	494	285	—	730	10,321
Ending balance	$1,396	$1,688	$ 6,453	$ 494	$288	$—	$ 730	$11,049

Six Months Ended June 30, 2013	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$1,614	$1,292	$ 2,814	$352	$288	$1	$5,423	$11,784
Provision for credit losses	1,362	600	158	27	24	(1)	(2,140)	30
Charge-offs	(349)	(216)	—	(136)	(27)	—	—	(728)

Recoveries	38	3	—	—	30	—	—	71
Net charge-offs	(311)	(213)	—	(136)	3	—	—	(657)
Ending balance	$2,665	$1,679	$ 2,972	$243	$315	$0	$3,283	$11,157
Period-end amount allocated to:								
Loans individually evaluated for impairment	380	139	2	—	—	—	14	535
Loans collectively evaluated for impairment	2,285	1,540	2,970	243	315	0	3,269	10,622
Ending balance	$2,665	$1,679	$ 2,972	$243	$315	$0	$3,283	$11,157

The following summarizes the activity in the allowance for credit losses by loan category for the quarters ended June 30, 2014 and 2013.

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Three Months Ended June 30, 2014	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$1,628	$1,644	$ 6,645	$412	$310	$—	$445	$11,084
Provision for credit losses	(201)	98	(321)	80	(40)	—	291	(93)
Charge-offs	(87)	(56)	—	—	5	—	(6)	(144)
Recoveries	56	2	129	2	13	—	—	202
Net charge-offs	(31)	(54)	129	2	18	—	(6)	58
Ending balance	$1,396	$1,688	$ 6,453	$494	$288	$—	$730	$11,049
Period-end amount allocated to:								
Loans individually evaluated for impairment	27	698	—	—	3	—	—	728
Loans collectively evaluated for impairment	1,369	990	6,453	494	285	—	730	10,321
Ending balance	$1,396	$1,688	$ 6,453	$494	$288	$—	$730	$11,049

Three Months Ended June 30, 2013	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	$1,462	$1,201	$ 1,805	$278	$250	$—	$6,407	$11,403
Provision for credit losses	1,240	569	1,167	101	86	—	(3,124)	39
Charge-offs	(59)	(93)	—	(136)	(24)	—	—	(312)
Recoveries	22	2	—	—	3	—	—	27
Net charge-offs	(37)	(91)	0	(136)	(21)	—	—	(285)
Ending balance	$2,665	$1,679	$ 2,972	$243	$315	$—	$3,283	$11,157
Period-end amount allocated to:								
Loans individually evaluated for impairment	380	139	2	—	—	—	14	535
Loans collectively evaluated for impairment	2,285	1,540	2,970	243	315	—	3,269	10,622

Ending balance	$2,665	$1,679	$ 2,972	$243	$315	$—	$3,283	$11,157

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The following summarizes information with respect to the loan balances at June 30, 2014 and December 31, 2013.

(000's)	June 30, 2014 Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans	December 31, 2013 Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and Business Loans	$615	$64,121	$64,736	$677	$67,783	$68,460
Government Program Loans	539	1,582	2,121	—	2,226	2,226
Total Commercial and Industrial	1,154	65,703	66,857	677	70,009	70,686
Commercial Real Estate Loans	8,113	145,589	153,702	10,189	133,730	143,919
Residential Mortgage Loans	4,644	44,146	48,790	5,384	46,652	52,036
Home Improvement and Home Equity Loans	—	1,231	1,231	—	1,410	1,410
Total Real Estate Mortgage	12,757	190,966	203,723	15,573	181,792	197,365
RE Construction and Development Loans	491	111,215	111,706	1,789	85,215	87,004
Agricultural Loans	38	31,439	31,477	45	30,887	30,932
Installment Loans	46	9,118	9,164	48	9,282	9,330
Total Loans	$14,486	$408,441	$422,927	$18,132	$377,185	$395,317

4. Deposits

Deposits include the following:

(In thousands)	June 30, 2014	December 31, 2013
Noninterest-bearing deposits	$227,092	$214,317
Interest-bearing deposits:		
NOW and money market accounts	194,589	198,928
Savings accounts	49,744	45,758
Time deposits:		
Under $100,000	27,022	28,825
$100,000 and over	57,618	54,661
Total interest-bearing deposits	328,973	328,172
Total deposits	$556,065	$542,489
Total brokered deposits included in time deposits above	$13,514	$11,500

5. Short-term Borrowings/Other Borrowings

At June 30, 2014, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling $283,153,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling $6,416,000. At June 30, 2014, the Company had an uncollateralized line of credit with Pacific Coast Bankers Bank ("PCBB") totaling $10,000,000. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time. There are currently no restrictions on these lines of credit, although under the current Written Agreement with the Federal Reserve, the Bank’s liquidity position as well as its use of borrowing lines is monitored closely. These lines of credit have interest rates that are generally tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company’s stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of June 30, 2014, $6,746,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, $371,621,000 in real estate secured loans were

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pledged at June 30, 2014, as collateral for borrowing lines with the Federal Reserve Bank totaling $283,153,000. At June 30, 2014, the Company had no outstanding borrowings.

At December 31, 2013, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling $254,761,000, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling $7,094,000. At December 31, 2013, the Company had an uncollateralized line of credit with Pacific Coast Bankers Bank ("PCBB") totaling $10,000,000. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2013, $7,468,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, $334,299,000 in real estate-secured loans were pledged at December 31, 2013, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling $254,761,000. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. At December 31, 2013, the Company had no outstanding borrowings.

6. Supplemental Cash Flow Disclosures

	Six Months Ended June 30,	
(In thousands)	2014	2013
Cash paid during the period for:		
Interest	$1,821	$752
Income taxes	$—	$—
Noncash investing activities:		
Loans transferred to foreclosed assets	$1,065	$437
OREO financed	$—	$2,328
Sale of limited partnership interest financed	$3,000	$—

7. Common Stock Dividend

On June 24, 2014, the Company's Board of Directors declared a one-percent (1%) stock dividend on the Company's outstanding common stock. Based upon the number of outstanding common shares on the record date of July 11, 2014, 149,448 additional shares were issued to shareholders on July 23, 2014. Because the stock dividend was considered a "small stock dividend," approximately $831,000 was transferred from retained earnings to common stock based upon the $5.56 closing price of the Company's common stock on the declaration date of June 24, 2014. There were no fractional shares paid. Except for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

During the first quarter of 2014, the Company's Board of Director's issued a one-percent (1%) stock dividend on the Company's outstanding common stock. Approximately $854,000 was transferred from retained earnings to common stock and 147,946 additional shares were issued to shareholders.

8. Net Income per Common Share

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation:

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income available to common shareholders (in thousands)	$2,047	$1,397	$2,956	$2,472
Weighted average shares issued	15,097,282	15,095,299	15,097,282	15,093,567
Add: dilutive effect of stock options	9,338	1,680	8,206	4,059
Weighted average shares outstanding adjusted for potential dilution	15,106,620	15,096,979	15,105,488	15,097,626
Basic earnings per share	$0.14	$0.09	$0.20	$0.16
Diluted earnings per share	$0.14	$0.09	$0.20	$0.16
Anti-dilutive stock options excluded from earnings per share calculation	151,000	165,000	151,000	169,000

9. Taxes on Income

The Company periodically reviews its tax positions under the accounting standards related to uncertainty in income taxes, which defines the criteria that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority and all available information is known to the taxing authority.

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At June 30, 2014 and December 31, 2013, the Company had no recorded valuation allowance.

The Company and its subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. During 2010, the Company amended its federal tax returns for the year 2004 through 2009 to utilize the five-year NOL carry-back provisions allowed by the IRS for 2009. These amended tax returns were audited by the IRS and the examination was finalized during the first quarter of 2013 and the settlement did not have a material impact on the Company's financial statements. The Company is no longer subject to examination by taxing authorities for years ending before 2010 for federal purposes and 2003 for California purposes. The Company's policy is to recognize any interest or penalties related to uncertain tax position in income tax expense.

10. Junior Subordinated Debt/Trust Preferred Securities

Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Company elected to defer interest payments on the Company's $15.0 million of junior subordinated debentures relating to its trust preferred securities. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals are elected, the Company will continue to record interest expense associated with the debentures. As of June 30, 2014, the Company ended the extension period and all accrued and unpaid interest was paid. The Company may redeem the junior subordinated debentures at anytime at par.

The fair value guidance generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. Effective January 1, 2008, the Company elected the fair value option for its junior subordinated debt issued under USB Capital Trust II. The rate paid on the junior subordinated debt issued under USB Capital Trust II is 3-month LIBOR plus 1.29, and is adjusted quarterly.

At June 30, 2014 the Company performed a fair value measurement analysis on its junior subordinated debt using a cash flow model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month LIBOR curve to estimate future quarterly interest payments due over the thirty-year life of the debt instrument. These cash flows were

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discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. Although there is little market data in the current relatively illiquid credit markets, we believe the 7.59% discount rate used represents what a market participant would consider under the circumstances based on current market assumptions.

The fair value calculation performed at June 30, 2014 resulted in a pretax loss adjustment of $129,000 ($76,000, net of tax) for the six months ended June 30, 2014, compared to a pretax loss adjustment of $660,000 ($388,000, net of tax) for the six months ended June 30, 2013.

The fair value calculation performed at June 30, 2014 resulted in a pretax gain adjustment of $216,000 ($127,000, net of tax) for the quarter ended June 30, 2014, compared to a pretax loss adjustment of $103,000 ($60,000, net of tax) for the quarter ended June 30, 2013.

11. Fair Value Measurements and Disclosure

The following summary disclosures are made in accordance with the guidance provided by ASC Topic 825, Fair Value Measurements and Disclosures (formerly Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments), which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate that value.

Generally accepted accounting guidance clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This guidance applies whenever other accounting pronouncements require or permit fair value measurements.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3). Level 1 inputs are unadjusted quoted prices in active markets (as defined) for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The table below is a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized at the periods indicated:
June 30, 2014

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	$120,699	$120,699	$120,699	$—	$—
Interest-bearing deposits	1,518	1,518	—	1,518	—
Investment securities	51,258	51,258	10,824	40,434	—
Loans	411,119	407,991	—	—	407,991
Accrued interest receivable	1,827	1,827	—	1,827	—
Financial Liabilities:					
Deposits:					

Noninterest-bearing	227,092	227,092	227,092	—	—
NOW and money market	194,589	194,589	194,589	—	—
Savings	49,744	49,744	49,744	—	—
Time Deposits	84,640	84,713	—	—	84,713
Total Deposits	556,065	556,138	471,425		84,713
Junior Subordinated Debt	10,082	10,082	—	—	10,082
Accrued interest payable	39	39	—	39	—

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December 31, 2013

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	$135,212	$135,212	$135,212	$—	$—
Interest-bearing deposits	1,515	1,515	—	1,515	—
Investment securities	43,616	43,616	10,746	32,870	—
Loans	384,025	380,615	—	—	380,615
Accrued interest receivable	1,644	1,644	—	1,644	—
Financial Liabilities:					
Deposits:					
Noninterest-bearing	214,317	214,317	214,317	—	—
NOW and money market	198,928	198,928	198,928	—	—
Savings	45,758	45,758	45,758	—	—
Time Deposits	83,486	83,362	—	—	83,362
Total Deposits	542,489	542,365	459,003	—	83,362
Junior Subordinated Debt	11,125	11,125	—	—	11,125
Accrued interest payable	44	44	—	44	—

The Company performs fair value measurements on certain assets and liabilities as the result of the application of current accounting guidelines. Some fair value measurements, such as available-for-sale securities (AFS) and junior subordinated debt are performed on a recurring basis, while others, such as impairment of loans, other real estate owned, goodwill and other intangibles, are performed on a nonrecurring basis.

The Company's Level 1 financial assets consist of money market funds and highly liquid mutual funds for which fair values are based on quoted market prices. The Company's Level 2 financial assets include highly liquid debt instruments of U.S. government agencies, collateralized mortgage obligations, and debt obligations of states and political subdivisions, whose fair values are obtained from readily-available pricing sources for the identical or similar underlying security that may, or may not, be actively traded. The Company's Level 3 financial assets include certain investments securities, certain impaired loans, other real estate owned, goodwill, and intangible assets where the assumptions may be made by us or third parties about assumptions that market participants would use in pricing the asset or liability. From time to time, the Company recognizes transfers between Level 1, 2, and 3 when a change in circumstances warrants a transfer. There were no significant transfers in or out of Level 1 and Level 2 fair value measurements during the three months ended June 30, 2014.

The following methods and assumptions were used in estimating the fair values of financial instruments:

Cash and Cash Equivalents - The carrying amounts reported in the balance sheets for cash and cash equivalents approximate their estimated fair values.

Interest-bearing Deposits – Interest bearing deposits in other banks consist of fixed-rate certificates of deposits. Accordingly, fair value has been estimated based upon interest rates currently being offered on deposits with similar characteristics and maturities.

Investments – Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a Level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a forward spread from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded through other comprehensive loss as the securities are available for sale.

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Loans - Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values adjusted for credit risk. Fair values for all other loans, except impaired loans, are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities.

Impaired Loans - Fair value measurements for impaired loans are performed pursuant to authoritative accounting guidance and are based upon either collateral values supported by appraisals, observed market prices, or discounted cash flows. Changes are not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve. Such adjustments to the estimated fair value of impaired loans may result in increases or decreases to the provision for credit losses recorded in current earnings. Collateral dependent loans are measured for impairment using the fair value of the collateral.

Other Real Estate Owned - Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Deposits – In accordance with authoritative accounting guidance, fair values for transaction and savings accounts are equal to the respective amounts payable on demand (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed under authoritative accounting guidance. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Junior Subordinated Debt – The fair value of the junior subordinated debt was determined based upon a discounted cash flows model utilizing observable market rates and credit characteristics for similar debt instruments. In its analysis, the Company used characteristics that market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. Cash flows are discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for credit and liquidity risks associated with similar junior subordinated debt and circumstances unique to the Company. The Company believes that the subjective nature of theses inputs, due primarily to the current economic environment, require the junior subordinated debt to be classified as a Level 3 fair value.

Accrued Interest Receivable and Payable - The carrying value of these instruments is a reasonable estimate of fair value.

Off-Balance Sheet Instruments - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at June 30, 2014 and December 31, 2013.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are not material to the Company's consolidated balance sheet and results of operations.

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at June 30, 2014 and 2013:

June 30, 2014				December 31, 2013			
Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average	Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average
Junior Subordinated Debt	Discounted cash flow	Discount Rate	7.59%	Junior Subordinated Debt	Discounted cash flow	Discount Rate	8.19%

Management believes that the credit risk adjusted spread utilized in the fair value measurement of the junior subordinated debentures carried at fair value is indicative of the nonperformance risk premium a willing market participant would require under current market conditions, that is, the inactive market. Management attributes the change in fair value of the junior subordinated debentures during the period to market changes in the nonperformance expectations and pricing of this type of

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debt, and not as a result of changes to our entity-specific credit risk. The narrowing of the credit risk adjusted spread above the Company's contractual spreads has primarily contributed to the negative fair value adjustments. Generally, an increase in the credit risk adjusted spread and/or a decrease in the three month LIBOR swap curve will result in positive fair value adjustments (and decrease the fair value measurement). Conversely, a decrease in the credit risk adjusted spread and/or an increase in the three month LIBOR swap curve will result in negative fair value adjustments (and increase the fair value measurement).

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of June 30, 2014 (in 000's):

Description of Assets	June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. Government agencies	$13,545	$—	$13,544	$—
U.S. Government collateralized mortgage obligations	33,912	7,023	26,890	—
Mutual Funds	3,801	3,801	—	—
Total AFS securities	$51,258	$10,824	$40,434	$—
Impaired loans (1):				
Commercial and industrial	—	—	—	—
Real estate mortgage	—	—	—	—
RE construction & development	—	—	—	—
Agricultural	—	—	—	—
Installment/Other	—	—	—	—
Total impaired loans	$—	$—	$—	$—
Other real estate owned (1)	—	—	—	—
Total	$51,258	$10,824	$40,434	$—

Description of Liabilities	June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	$10,082	—	—	$10,082
Total	$10,082	—	—	$10,082

(1)Nonrecurring
(2)Recurring

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2013 (in 000's):

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Description of Assets	December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. Government agencies	$14,500	$—	$14,500	$—
U.S. Government collateralized mortgage obligations	25,386	7,016	18,370	—
Mutual Funds	3,730	3,730	—	—
Total AFS securities	43,616	10,746	32,870	$—
Impaired Loans (1):				
Commercial and industrial	—	—	—	—
Real estate mortgage	1,388	—	—	1,388
RE construction & development	—	—	—	—
Agricultural	—	—	—	—
Installment/Other	—	—	—	—
Total impaired loans	$1,388	$—	$—	$1,388
Other real estate owned (1)	3,889	—	—	3,889
Total	$48,893	$10,746	$32,870	$5,277

Description of Liabilities	December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	$11,125	$—	$—	$11,125
Total	$11,125	$—	$—	$11,125

(1)Nonrecurring
(2)Recurring

The Company recorded no impairment loss on other real estate owned during the three and six months ended June 30, 2014. There were no fair value impairment adjustments for the nonrecurring fair value measurements performed during the three and six months ended June 30, 2014.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and six months ended June 30, 2014 and 2013 (in 000's):

Reconciliation of Liabilities:	Three Months Ended June 30, 2014 Junior Subordinated Debt	Six Months Ended June 30, 2014 Junior Subordinated Debt	Three Months Ended June 30, 2013 Junior Subordinated Debt	Six Months Ended June 30, 2013 Junior Subordinated Debt
Beginning balance	$11,532	$11,125	$10,685	$10,068
Total losses (gains) included in earnings (or changes in net assets)	(216)	129	103	660
Capitalized interest	(1,234)	(1,172)	94	154

Ending balance	$10,082	$10,082	$10,882	$10,882
The amount of total losses (gains) for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date	$(216)	$129	$103	$660

12. Goodwill and Intangible Assets

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At June 30, 2014 and December 31, 2013, the Company had goodwill, core deposit intangibles, and other identified intangible assets which were recorded in connection with various business combinations and purchases. The following table summarizes the carrying value of those assets at June 30, 2014 and December 31, 2013.

	June 30, 2014	December 31, 2013
Goodwill	$4,488	$4,488
Core deposit intangible assets	—	62
Total goodwill and intangible assets	$4,488	$4,550

Core deposit intangibles are amortized over their useful lives, while goodwill is not amortized. The Company conducts periodic impairment analysis on goodwill and intangible assets at least annually or more often as conditions require.

Goodwill: The largest component of goodwill is related to the Legacy merger (Campbell reporting unit) completed during February 2007 and totaled approximately $2.9 million at June 30, 2014. The Company completed a "Step 0" analysis for the Campbell reporting unit as of March 31, 2014, and a "Step 1" at March 31, 2013, with no goodwill impairment.

The first step in impairment testing is to identify potential impairment, which involves determining and comparing the fair value of the operating unit with its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired. If the carrying value exceeds fair value, there is an indication of possible impairment and the second step is performed to determine the amount of the impairment, if any. The fair value determined in the step one testing is determined based on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the Campbell reporting unit. In addition to projected cash flows, the Company also utilizes other market metrics including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes is discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If, at the conclusion of the step 1 analysis, the Company concludes that the potential for goodwill impairment exists, step-two testing will be required to determine goodwill impairment and the amount of goodwill that might be impaired, if any. The second step in impairment analysis compares the fair value of the Campbell reporting unit to the aggregate fair values of its individual assets, liabilities and identified intangibles. Based on the results of the first step of the impairment analysis at March 31, 2013, the Company concluded that that the fair value of the reporting unit exceeds it carrying value. Therefore, goodwill was not impaired.

Core Deposit Intangibles: The core deposit intangible asset related to the Legacy Bank Merger, which totaled $3.0 million at the time of merger, was amortized over an estimated life of approximately seven years. At June 30, 2014, there was no remaining carrying value of the core deposit intangible related to the Legacy Bank merger. The Company recognized no amortization expense related to the Legacy operating unit during the six months ended June 30, 2014. The Company recognized no amortization expense related to the Legacy operating unit during the six months ended June 30, 2013. At June 30, 2014, there was no remaining carrying value of core deposit intangible related to the Taft branch acquisitions completed in April 2004.

The Company did not record an impairment loss for the six months ended June 30, 2014 or June 30, 2013.

13. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Unrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued.

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

Overview

Certain matters discussed or incorporated by reference in this Quarterly Report of Form 10-Q 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, but are not limited to, those described in Management's Discussion and Analysis of Financial Condition and Results of Operations. Such risks and uncertainties include, but are not limited to, the following factors: i) competitive pressures in the banking industry and changes in the regulatory environment; ii) exposure to changes in the interest rate environment and the resulting impact on the Company's interest rate sensitive assets and liabilities; iii) decline in the health of the economy nationally or regionally which could reduce the demand for loans or reduce the value of real estate collateral securing most of the Company's loans; iv) credit quality deterioration that could cause an increase in the provision for loan losses; v) Asset/Liability matching risks and liquidity risks; volatility and devaluation in the securities markets, vi) failure to comply with the regulatory agreements under which the Company is subject, vii) expected cost savings from recent acquisitions are not realized, and, viii) potential impairment of goodwill and other intangible assets. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

United Security Bancshares (the "Company" or "Holding Company") is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. United Security Bank (the "Bank") is a wholly-owned bank subsidiary of the Company and was formed in 1987. References to the Company are references to United Security Bancshares (including the Bank). References to the Bank are to United Security Bank, while references to the Holding Company are to the parent-only, United Security Bancshares. The Company currently has eleven banking branches, which provide financial services in Fresno, Madera, Kern, and Santa Clara counties in the state of California.

Effective March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a formal written agreement (the "Agreement") with the Federal Reserve Bank of San Francisco. The Agreement was a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009 and is intended to improve the overall condition of the Bank through, among other things, increased Board oversight; formal plans to monitor and improve processes related to asset quality, liquidity, funds management, capital, and earnings; and the prohibition of certain actions that might reduce capital, including the distribution of dividends or the repurchase of the Company's common stock. The Board of Directors and management believe that the Company is in compliance with the terms of the Agreement. (For more information on the Agreement see the "Regulatory Matters" section included in this Management's Discussion and Analysis of Financial Condition and Results of Operations.)

During May of 2010, the California Department of Business Oversight (formerly known as the California Department of Financial Institutions) issued a written order (the "Order") to the Bank as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Business Oversight in June 2009. The Order issued by the California Department of Business Oversight is similar to the written agreement with the Federal Reserve Bank of San Francisco. As of September 24, 2013, the Bank entered into a Memorandum of Understanding (the "MOU") with the California Department of Business Oversight. Effective October 15, 2013, the Order was officially terminated by the California Department of Business Oversight. The Board of Directors and management believe that the Company is in compliance with the terms of the MOU. (For more information on the Agreement see the "Regulatory Matters" section included in this Management's Discussion and Analysis of Financial Condition and

Results of Operations.)

Trends Affecting Results of Operations and Financial Position

The Company’s overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact the results of operations, but also the composition of the Company’s balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth. Net interest income before provision for credit losses has increased between the six months ended June 30, 2014 and 2013, totaling $11,381,000 for the six months ended June 30, 2014 as compared to $10,602,000 for the six months ended June 30, 2013. The increase in net interest income between 2013 and 2014 was primarily the result of a shift in the asset mix as well as a decrease in the Company’s cost of funding between the two periods which outweighed the decline in the yield on interest-earning assets.

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Average interest-earning assets increased approximately $35,511,000 between the six months ended June 30, 2014 and 2013. Components of the $35,511,000 increase in average earning assets between 2013 and 2014 included an increase of $9,069,000 in loans, a $19,939,000 increase in investment securities and an increase of $6,496,000 in overnight funds sold to the Federal Reserve Bank. During the past year, the Company's cost of interest-bearing liabilities have continued to decline, with the average cost of interest-bearing liabilities dropping from 0.52% during the six months ended June 30, 2013, to 0.38% during the six months ended June 30, 2014.

Net interest income before provision for credit losses has increased between the quarters ended June 30, 2014 and 2013, totaling $5,916,000 for the quarter ended June 30, 2014 as compared to $5,342,000 for the quarter ended June 30, 2013. The increase in net interest income between 2013 and 2014 was primarily the result of purchases of investment securities and growth of the loan portfolio.

The following table summarizes the year-to-date averages of the components of interest-earning assets as a percentage of total interest-earning assets and the components of interest-bearing liabilities as a percentage of total interest-bearing liabilities:

	YTD Average 6/30/14	YTD Average 12/31/13	YTD Average 6/30/13
Loans and Leases	69.90%	70.75%	72.80%
Investment securities available for sale	8.39%	5.45%	5.27%
Interest-bearing deposits in other banks	0.26%	0.27%	0.28%
Interest-bearing deposits in FRB	21.45%	23.53%	21.65%
Total interest-earning assets	100.00%	100.00%	100.00%
NOW accounts	17.53%	15.56%	15.27%
Money market accounts	40.67%	41.96%	41.37%
Savings accounts	13.95%	12.40%	12.36%
Time deposits	24.54%	27.00%	27.98%
Other borrowings	0.00%	0.00%	0.00%
Subordinated debentures	3.31%	3.08%	3.02%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

The residential real estate markets in the five county region from Merced to Kern showed signs of improvement since 2013 and those trends continued into the second quarter of 2014. The severe declines in residential construction and home prices that began in 2008 continue to show signs of easing and reversing direction. The sustained period of double-digit price declines from 2008 – 2011 adversely impacted the Company's operations and increased the levels of nonperforming assets, increased expenses related to foreclosed properties, and decreased profit margins. As the Company continues its business development and expansion efforts throughout its market areas, a primary focus is reduction of nonperforming assets while providing customers options to work through this difficult economic period. Options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices improved in the five county region from Merced to Kern between June 2013 to June 2014. Total nonperforming loans decreased during the six months ended June 30, 2014, totaling $14,569,000 at June 30, 2014 compared to $18,102,000 reported at December 31, 2013.

As a result of a modest improvement in the economy, the Company has experienced improvement in the loan portfolio between 2013 and 2014. During the six months ended June 30, 2014, the Company experienced increases in real estate construction development and real estate mortgage loans, but experienced decreases in commercial and industrial loans, compared to the same period ended June 30, 2013. Loans increased $27,610,000 between

December 31, 2013 and June 30, 2014, and increased $17,886,000 between June 30, 2013 and June 30, 2014. Commercial and industrial loans decreased $3,829,000 between December 31, 2013 and June 30, 2014 and decreased $8,922,000 between June 30, 2013 and June 30, 2014. Real estate mortgage loans increased $6,358,000 between December 31, 2013 and June 30, 2014, and $536,000 between June 30, 2013 and June 30, 2014. Agricultural loans increased $545,000 between December 31, 2013 and June 30, 2014 and increased $2,450,000 between June 30, 2013 and June 30, 2014. Commercial real estate loans (a component of real estate mortgage loans) have remained as a significant percentage of total loans over the past year, amounting to 36.34%, 36.41%, and 36.20%, of the total loan portfolio at June 30, 2014, December 31, 2013, and June 30, 2013, respectively. Residential mortgage loans are not

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generally a large part of the Company’s loan portfolio, but some residential mortgage loans have been made over the past several years to facilitate take-out loans for construction borrowers when they were not able to obtain permanent financing elsewhere. These loans are generally 30-year amortizing loans with maturities of between three and five years. Residential mortgages totaled $48,790,000 or 11.54% of the portfolio at June 30, 2014, $52,036,000, or 13.16% of the portfolio at December 31, 2013, and $54,972,000 or 13.57% of the portfolio at June 30, 2013. Loan participations purchased have remained the same from $30,000 or 0.01% of the portfolio at June 30, 2013, to $30,000 or 0.01% of the portfolio at December 31, 2013, but have increased to $888,000 or less than 0.21% of the portfolio at June 30, 2014. Loan participations sold decreased from $12,412,000 or 3.06% of the portfolio at June 30, 2013, to $9,786,000 or 2.5% of the portfolio at December 31, 2013, to $9,516,000, or 2.3%, at June 30, 2014.

Although market rates of interest are at historically low levels, the Company’s disciplined deposit pricing efforts have helped maintain adequate margins. The Company’s net interest margin increased to 3.97% for the six months ended June 30, 2014, when compared to 3.94% for the six months ended June 30, 2013. The net interest margin has been impacted slightly by increases in the loan portfolio and purchases of investment securities, both of which are higher yielding assets compared to overnight investments with the Federal Reserve Bank. The Company has successfully sought to mitigate the low-interest rate environment with loan floors included in new and renewed loans when practical. Loans yielded 5.69% during the six months ended June 30, 2014, as compared to 5.62% for the six months ended June 30, 2013. The decrease in the Company’s cost of funds over the past year has mitigated the impact of declining yields on earning assets. The Company’s average cost of funds was 0.38% for the six months ended June 30, 2014, as compared to 0.52% for the six months ended June 30, 2013. Although the Company does not intend to increase its current level of brokered deposits, the levels of brokered deposits are expected to remain level at least in the short-term. The Company is currently only utilizing CDARs reciprocal deposits as a concession to our customers. The $13,514,000 in brokered deposits at June 30, 2014 continues to provide the Company with a low-cost source of deposits. The Company will continue to utilize these funding sources when required to maintain prudent liquidity levels, while seeking to increase core deposits when possible.

Total noninterest income of $2,822,000 reported for the six months ended June 30, 2014 increased $1,196,000 or 73.55% as compared to the six months ended June 30, 2013. Noninterest income continues to be driven by customer service fees, which totaled $1,682,000 for the six months ended June 30, 2014. However, the increase in noninterest income between the two periods was primarily the result of a $531,000 decrease in loss on fair value of financial liability as well as a $691,000 gain on sale of investment during the six months ended June 30, 2014.

Noninterest expense increased approximately $1,311,000 or 15.94% between the six months ended June 30, 2013 and June 30, 2014. The increase experienced during the six months ended June 30, 2014, was primarily the result of an increase of $1,582,000 in the net operating cost on OREO.

Effective March 31, 2009, and beginning with the quarterly interest payment due October 1, 2009, the Company deferred interest payments on the Company's $15.0 million of junior subordinated debentures relating to its trust preferred securities. This was the result of regulatory restraints which have precluded the Bank from paying dividends to the Holding Company. The Agreement with the Federal Reserve Bank entered into during March 2010 specifically prohibits the Company and the Bank from making any payments on the junior subordinated debt without prior approval of the Federal Reserve Bank. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals are elected, the Company will continue to record interest expense associated with the debentures. As of June 30, 2014, the Company ended the extension period and all accrued and unpaid interest was paid.

The Company has not paid any cash dividends on its common stock since the second quarter of 2008 and does not expect to resume cash dividends on its common stock for the foreseeable future. Pursuant to the Agreement entered into with the Federal Reserve Bank during March of 2010, the Company and the Bank are precluded from paying cash dividends without prior consent of the Federal Reserve Bank. On June 24, 2014, the Company's Board of Directors declared a one-percent (1%) quarterly stock dividend on the Company's outstanding common stock. The Company believes, given the current uncertainties in the economy and unprecedented declines in real estate valuations in our markets, it is prudent to retain capital in this environment, and better position the Company for future growth opportunities. Based upon the number of outstanding common shares on the record date of July 11, 2014, an additional 149,448 shares were issued to shareholders.

For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to the 1% stock dividends to shareholders for all periods presented.

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The Company has sought to maintain a strong, yet conservative balance sheet while continuing to reduce the level of nonperforming assets and improve liquidity during the six months ended June 30, 2014. Total assets increased approximately $16,881,000 during the six months ended June 30, 2014, including an increase of $27,094,000 in net loans and an increase of $7,642,000 in investment securities. Total deposits increased $13,576,000, including an increase of $12,775,000 in noninterest-bearing deposits and $1,154,000 in time deposits, partially offset by decreases of $353,000 in savings and NOW and money market accounts during the six months ended June 30, 2014. Average loans comprised approximately 69.90% and 72.80% of overall average earning assets during the six months ended June 30, 2014 and June 30, 2013, respectively.

Nonperforming assets, which are primarily related to the real estate loan and other real estate owned portfolio, remained high during the six months ended June 30, 2014, but decreased $3,379,000 from a balance of $32,048,000 at December 31, 2013 to a balance of $28,669,000 at June 30, 2014. Nonaccrual loans totaling $9,549,000 at June 30, 2014, decreased $2,792,000 from the balance of $12,341,000 reported at December 31, 2013. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans decreased $3,646,000 during the six months ended June 30, 2014 with a balance of $14,486,000 at June 30, 2014. Other real estate owned through foreclosure increased $154,000 between December 31, 2013 and June 30, 2014 as a result of three properties being added to OREO. As a result of the related events, nonperforming assets as a percentage of total assets decreased from 5.04% at December 31, 2013 to 4.39% at June 30, 2014.

The following table summarizes various nonperforming components of the loan portfolio, the related allowance for loan and lease losses and provision for credit losses for the periods shown.

(in thousands)	June 30, 2014		December 31, 2013		June 30, 2013	
(Benefit) provision for credit losses during period	$(140	)	$(1,098	)	$30	
Allowance as % of nonperforming loans	75.84	%	60.70	%	50.99	%
Nonperforming loans as % total loans	3.44	%	4.58	%	5.40	%
Restructured loans as % total loans	1.80	%	2.29	%	3.69	%

Management continues to monitor economic conditions in the real estate market for signs of further deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Greater focus has been placed on monitoring and reducing the level of problem assets, while working with borrowers to find more options, including loan restructures, to work through these difficult economic times. Restructured loans comprise 27 loans totaling $7,627,000 at June 30, 2014, compared to 35 loans totaling $9,059,000 at December 31, 2013.

The Company recorded a negative provision of $140,000 to the allowance for credit losses during the six months ended June 30, 2014, as compared to a provision of $30,000 for the six months ended June 30, 2013. Net loan and lease recoveries during the six months ended June 30, 2014 totaled $201,000 as compared to net charge-offs of $657,000 for the six months ended June 30, 2013. The Company charged-off, or had partial charge-offs on, approximately 8 loans during the six months ended June 30, 2014, as compared to 5 loans during the same period ended June 30, 2013, and 24 loans during the year ended December 31, 2013. The annualized percentage net recoveries to average loans were 0.10% and net charge-offs to average loans were 0.34% for the six months ended June 30, 2014 and 2013, respectively, as compared to net recoveries of 0.08% for the year ended December 31, 2013.

Deposits increased by $13,576,000 during the six months ended June 30, 2014, primarily due to increases experienced in non-interest bearing deposits. The Company continues to maintain a low reliance on brokered deposits and other wholesale funding sources, while maintaining sufficient liquidity. Brokered deposits totaled $13,514,000 or 2.43% of total deposits at June 30, 2014, as compared to $11,500,000 or 2.12% of total deposits at December 31, 2013, and $16,232,000 or 2.97% of total deposits at June 30, 2013.

The cost of the Company’s subordinated debentures issued by USB Capital Trust II has remained low as market rates have remained low during the first six months of 2014. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 1.52% at June 30, 2014, as compared to 1.54% at December 31, 2013. Pursuant to fair value accounting guidance, the Company has recorded $129,000 in pretax fair value loss on its junior subordinated debt during the six months ended June 30, 2014, bringing the total cumulative gain recorded on the debt to $5,382,000 at June 30, 2014.

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The Company continues to emphasize relationship banking and core deposit growth, and has focused greater attention on its market area of Fresno, Madera, and Kern Counties, as well as Campbell, in Santa Clara County. The San Joaquin Valley and other California markets continue to exhibit weak demand for construction lending and commercial lending from small and medium size businesses, as commercial and residential real estate markets have shown improvements but still remain depressed, compared with prior years.

Results of Operations

On a year-to-date basis, the Company reported net income of $2,956,000 or $0.20 per share ($0.20 diluted) for the six months ended June 30, 2014, as compared to $2,472,000 or $0.16 per share ($0.16 diluted) for the same period in 2013. The Company's return on average assets was 0.90% for the six months ended June 30, 2014, as compared to 0.78% for the six months ended June 30, 2013. The Bank's return on average equity was 7.64% for the six months ended June 30, 2014, as compared to 7.04% for the six months ended June 30, 2013.

For the quarters ended June 30, 2014 and 2013, the Company reported net income of $2,047,000 or $0.14 per share ($0.14 diluted) and $1,397,000 or $0.09 per share ($0.09 diluted), respectively. The Company's return on average assets was 1.25% for the quarter ended June 30, 2014, compared to 0.88% for the quarter ended June 30, 2013. The Bank's return on average equity was was 10.44% for the quarter ended June 30, 2014, compared to 7.85% for the quarter ended June 30, 2013.

Net Interest Income

Net interest income before provision for credit losses totaled $11,381,000 for the six months ended June 30, 2014, representing an increase of $779,000, or 7.35%, when compared to the $10,602,000 reported for the same period of the previous year.

The Company's year-to-date net interest margin, as shown in Table 1, increased to 3.97% at June 30, 2014 from 3.94% at June 30, 2013, a increase of 3 basis points (100 basis points = 1%) between the two periods. While average market rates of interest have remained level between the six months ended June 30, 2014 and 2013 (the Prime rate averaged 3.25% during both periods), the decrease in the Company's yield on loans and investment securities, as well as a change in the earning asset mix to lower earning assets, negatively impacted the net margin between the two periods.

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Table 1. Distribution of Average Assets, Liabilities and Shareholders' Equity:
Interest rates and Interest Differentials
Six Months Ended June 30, 2014 and 2013

	2014				2013			
(dollars in thousands)	Average Balance	Interest	Yield/Rate		Average Balance	Interest	Yield/Rate	
Assets:								
Interest-earning assets:								
Loans and leases (1)	$404,207	$11,415	5.69	%	$395,138	$11,020	5.62	%
Investment Securities – taxable	48,534	461	1.92	%	28,595	338	2.38	%
Interest-bearing deposits in other banks	1,516	3	0.40	%	1,509	4	0.53	%
Interest-bearing deposits in FRB	124,032	147	0.24	%	117,536	135	0.23	%
Total interest-earning assets	578,289	$12,026	4.19	%	542,778	$11,497	4.27	%
Allowance for credit losses	(11,061)				(11,506)			
Noninterest-earning assets:								
Cash and due from banks	19,653				22,892			
Premises and equipment, net	12,062				12,077			
Accrued interest receivable	1,369				1,302			
Other real estate owned	14,131				21,675			
Other assets	46,102				47,665			
Total average assets	$660,545				$636,883			
Liabilities and Shareholders' Equity:								
Interest-bearing liabilities:								
NOW accounts	$59,985	$31	0.10	%	$52,757	$31	0.12	%
Money market accounts	139,230	238	0.34	%	142,810	354	0.50	%
Savings accounts	47,755	46	0.19	%	42,650	43	0.20	%
Time deposits	83,989	206	0.49	%	96,569	314	0.66	%
Other borrowings	—	—	0.00	%	—	—	0.00	%
Junior subordinated debentures	11,317	124	2.21	%	10,410	153	2.96	%
Total interest-bearing liabilities	342,276	$645	0.38	%	345,196	$895	0.52	%
Noninterest-bearing liabilities:								
Noninterest-bearing checking	232,495				214,801			
Accrued interest payable	69				104			
Other liabilities	7,724				5,938			
Total Liabilities	582,564				566,039			
Total shareholders' equity	77,981				70,844			
Total average liabilities and shareholders' equity	$660,545				$636,883			
Interest income as a percentage of average earning assets			4.19	%			4.27	%
Interest expense as a percentage of average earning assets			0.22	%			0.33	%
Net interest margin			3.97	%			3.94	%

(1)

Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately $188,000 and $21,000 for the six months ended June 30, 2014 and 2013, respectively.

Interest rates and Interest Differentials

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Three Months Ended June 30, 2014 and 2013

(dollars in thousands)	2014 Average Balance	2014 Interest	2014 Yield/Rate	2013 Average Balance	2013 Interest	2013 Yield/Rate
Assets:						
Interest-earning assets:						
Loans and leases (1)	$413,039	$5,940	5.77 %	$396,203	$5,554	5.62 %
Investment Securities – taxable	52,223	233	1.79 %	26,396	140	2.13 %
Interest-bearing deposits in other banks	1,517	1	0.26 %	1,510	2	0.53 %
Interest-bearing deposits in FRB	107,394	64	0.24 %	119,860	70	0.23 %
Total interest-earning assets	574,173	$6,238	4.36 %	543,969	$5,766	4.25 %
Allowance for credit losses	(11,106)			(11,257)		
Noninterest-earning assets:						
Cash and due from banks	18,746			22,773		
Premises and equipment, net	12,036			11,978		
Accrued interest receivable	1,437			1,287		
Other real estate owned	14,281			20,005		
Other assets	45,117			46,853		
Total average assets	$654,684			$635,608		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
NOW accounts	$61,169	$16	0.10 %	$52,829	$16	0.12 %
Money market accounts	136,100	118	0.35 %	138,877	143	0.41 %
Savings accounts	48,232	25	0.21 %	42,204	20	0.19 %
Time deposits	83,880	100	0.48 %	95,281	152	0.64 %
Other borrowings	—	—	0.00 %	—	—	0.00 %
Junior subordinated debentures	11,481	63	2.20 %	10,721	93	3.48 %
Total interest-bearing liabilities	340,862	$322	0.38 %	339,912	$424	0.50 %
Noninterest-bearing liabilities:						
Noninterest-bearing checking	227,021			218,089		
Accrued interest payable	69			97		
Other liabilities	8,067			6,076		
Total Liabilities	576,019			564,174		
Total shareholders' equity	78,665			71,434		
Total average liabilities and shareholders' equity	$654,684			$635,608		
Interest income as a percentage of average earning assets			4.36 %			4.25 %
Interest expense as a percentage of average earning assets			0.22 %			0.31 %
Net interest margin			4.14 %			3.94 %

(1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately $110,000 and $13,000 for the quarters ended June 30, 2014 and 2013, respectively.

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Both the Company's net interest income and net interest margin are affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as "volume change." Both are also affected by changes in yields on interest-earning assets and rates paid on interest-bearing liabilities, referred to as "rate change." The following table sets forth the changes in interest income and interest expense for each major category of interest-earning asset and interest-bearing liability, and the amount of change attributable to volume and rate changes for the periods indicated.

Table 2. Rate and Volume Analysis

	Increase (decrease) in the six months ended June 30, 2014 compared to June 30, 2013		
(In thousands)	Total	Rate	Volume
Increase (decrease) in interest income:			
Loans and leases	$395	$140	$255
Investment securities available for sale	123	(77)	200
Interest-bearing deposits in other banks	(1)	(1)	—
Interest-bearing deposits in FRB	12	4	8
Total interest income	529	66	463
Increase (decrease) in interest expense:			
Interest-bearing demand accounts	(116)	(123)	7
Savings and money market accounts	3	(2)	5
Time deposits	(108)	(71)	(37)
Other borrowings	—	0	—
Subordinated debentures	(29)	(41)	12
Total interest expense	(250)	(237)	(13)
Increase in net interest income	$779	$303	$476

For the six months ended June 30, 2014, total interest income increased approximately $529,000 or 4.60% as compared to the six months ended June 30, 2013. Earning asset volumes increased in investment securities available for sale, loans and leases, and interest-bearing deposits in other banks between the two periods with a large increases experienced in investment securities and loans and leases, which on average increased $19,939,000 and $9,069,000, respectively, between the two periods. The average rates on loans increased 7 basis points between the two periods, and the average rate on investment securities decreased approximately 47 basis points during the six months ended June 30, 2014 as compared to the same period of 2013.

For the six months ended June 30, 2014, total interest expense decreased approximately $250,000, or 27.93% as compared to the six months ended June 30, 2013. Between those two periods, average interest-bearing liabilities decreased by $2,920,000, while the average rates paid on these liabilities decreased by 14 basis points.

For the quarter ended June 30, 2014, total interest income increased $472,000 or 8.19%, as compared to the quarter ended June 30, 2013. Comparing those two periods, average interest earning assets increased $30,204,000, with the large increases experienced in investment securities and loans and leases. The average rate on total interest-earning assets increased 11 basis points, primarily due to an increase of 15 basis points on average rates paid on loans. For the quarter ended June 30, 2014, total interest expense decreased $102,000 or 24.06% as compared to the quarter ended June 30, 2013, as a result of a 12 basis point decrease on the average rates paid on interest-bearing liabilities. The average rate paid on interest-bearing liabilities was 0.38% for the quarter ended June 30, 2014, compared to 0.50% for the same period ended June 30, 2013.

Provisions for credit losses are determined on the basis of management's periodic credit review of the loan portfolio, consideration of past loan loss experience, current and future economic conditions, and other pertinent factors. Such factors consider the allowance for credit losses to be adequate when it covers estimated losses inherent in the loan portfolio. Based on the condition of the loan portfolio, management believes the allowance is sufficient to cover risk elements in the loan portfolio.

For the six months ended June 30, 2014, the provision to the allowance for credit losses amounted to a benefit of $140,000 as compared to a provision of $30,000 for the six months ended June 30, 2013. For the quarter ended June 30, 2014, the provision to the allowance for credit losses amounted to a benefit of $93,000, as compared to a provision of $39,000 for the quarter ended June 30, 2013.

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The amount provided to the allowance for credit losses during the first six months of 2014 brought the allowance to 2.62% of net outstanding loan balances at June 30, 2014, as compared to 2.78% of net outstanding loan balances at December 31, 2013, and 2.75% at June 30, 2013.

Table 3. Changes in Noninterest Income

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2014 and 2013:

(In thousands)	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Amount of Change	Percent Change
Customer service fees	$1,682	$1,681	$1	0.06 %
Increase in cash surrender value of BOLI	255	277	(22)	(7.94)%
Loss on fair value of financial liability	(129)	(660)	531	(80.45)%
Gain on sale of other investment	691	—	691	100.00 %
Gain on sale of fixed assets	25	—	25	100.00 %
Other	298	328	(30)	(9.15)%
Total noninterest income	$2,822	$1,626	$1,196	73.55 %

Noninterest income for the six months ended June 30, 2014 increased $1,196,0000 or 73.55% when compared to the same period of 2013. Customer service fees, the primary component of noninterest income, increased $1,000 or 0.06% between the two periods presented. The increase in noninterest income of $1,196,000 between the two periods includes a reduction in the loss on fair value of financial liability and a gain on sale of a real estate limited partnership interest. The change in the fair value of financial liability is primarily caused by a modest decline in Libor rates beyond two years as compared to the previous quarter.

Noninterest Expense

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2014 and 2013:

Table 4. Changes in Noninterest Expense

(In thousands)	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Amount of Change	Percent Change
Salaries and employee benefits	$4,805	$4,474	$331	7.40 %
Occupancy expense	1,829	1,788	41	2.29 %
Data processing	69	93	(24)	(25.81)%
Professional fees	507	820	(313)	(38.17)%
FDIC/DFI insurance assessments	472	698	(226)	(32.38)%
Director fees	117	117	—	— %
Amortization of intangibles	62	93	(31)	(33.33)%
Correspondent bank service charges	59	157	(98)	(62.42)%
Loss on California tax credit partnership	47	65	(18)	(27.69)%
Net (gain) cost on operation of OREO	364	(1,218)	1,582	(129.89)%
Other	1,207	1,140	67	5.88 %
Total expense	$9,538	$8,227	$1,311	15.94 %

Noninterest expense increased $1,311,000 between the six months ended June 30, 2014 and 2013. The net increase in noninterest expense between the comparative periods is primarily the result of a increase on net cost of operation on OREO due to gains on sale of OREO realized in 2013.

Included in net costs on operations of OREO for the six months ended June 30, 2014, are OREO operating expenses totaling $471,000, partially offset by $107,000 in gains on sale of OREO. Net operating cost on operations of OREO for the six months

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ended June 30, 2013, includes gains on sale of OREO of $1,949,000, which were partially offset by OREO operating expenses of $613,000.

Income Taxes

The Company's income tax expense is impacted to some degree by permanent taxable differences between income reported for book purposes and income reported for tax purposes, as well as certain tax credits which are not reflected in the Company's pretax income or loss shown in the statements of operations and comprehensive income. As pretax income or loss amounts become smaller, the impact of these differences become more significant and are reflected as variances in the Company's effective tax rate for the periods presented. In general, permanent differences and tax credits affecting tax expense have a positive impact and tend to reduce the effective tax rates shown in the Company's statements of operations and comprehensive income.

The Company reviews its current tax positions at least quarterly based upon accounting standards related to uncertainty in income taxes which includes the criteria required for the income tax benefit, all or in part, to be recognized in a taxable entity's financial statements. Under the income tax guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority. The Company has reviewed all of its tax positions as of June 30, 2014, and has determined that there are no material amounts that should be recorded under the current income tax accounting guidelines.

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At June 30, 2014 and December 31, 2013, the Company had no recorded valuation allowance. The Company performs an analysis of the valuation allowance considering both tax planning strategies and future earnings as a basis for utilizing the deferred tax assets. The tax planning strategies include the sale of certain bank premise and the surrender of Bank Owned Life Insurance. In its review of a requirement for a valuation allowance, the Company identifies both positive and negative evidence to determine whether a valuation allowance is required.

Financial Condition

Total assets increased $16,881,000, or 2.65% to a balance of $652,810,000 at June 30, 2014, from the balance of $635,929,000 at December 31, 2013, and increased $17,148,000, or 2.70%, from the balance of $635,662,000 at June 30, 2013. Total deposits of $556,065,000 at June 30, 2014, increased $13,576,000, or 2.50% from the balance reported at December 31, 2013, and increased $8,964,000, or 1.64%, from the balance of $547,101,000 reported at June 30, 2013. Cash and cash equivalents decreased $14,513,000, or 10.73%, between December 31, 2013 and June 30, 2014; net loans increased $27,094,000, or 7.06% to a balance of $411,119,000; and investment securities increased by $7,642,000, or 17.52% during the first six months of 2014.

Earning assets averaged approximately $578,289,000 during the six months ended June 30, 2014, as compared to $542,778,000 for the same period of 2013. Average interest-bearing liabilities decreased to $342,276,000 for the six months ended June 30, 2014, from $345,196,000 reported for the comparative period of 2013.

Loans and Leases

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of earning assets. Loans totaled $422,927,000 at June 30, 2014, an increase of $27,610,000, or 6.98%, when compared to the balance of $395,317,000 at December 31, 2013, and an increase of

$17,886,000, or 4.42%, when compared to the balance of $405,041,000 reported at June 30, 2013. Loans on average increased $9,069,000, or 2.30%, between the six months ended June 30, 2013 and June 30, 2014, with loans averaging $404,207,000 for the six months ended June 30, 2014, as compared to $395,138,000 for the same period of 2013.

During the first six months of 2014, decreases of $3,829,000 and $166,000 were experienced in commercial and industrial loans and installment loans, respectively. Real estate construction and real estate mortgage loans increased $24,702,000 or 28.39%, and $6,358,000 or 3.22%, respectively, during the first six months of 2014.

The following table sets forth the amounts of loans outstanding by category at June 30, 2014 and December 31, 2013, the category percentages as of those dates, and the net change between the two periods presented.

Table 5. Loans

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(In thousands)	June 30, 2014 Dollar Amount	% of Loans	December 31, 2013 Dollar Amount	% of Loans	Net Change	% Change
Commercial and industrial	$66,857	15.8 %	$70,686	17.9 %	$(3,829)	(5.42)%
Real estate – mortgage	203,723	48.2 %	197,365	49.9 %	6,358	3.22 %
RE construction & development	111,706	26.4 %	87,004	22.0 %	24,702	28.39 %
Agricultural	31,477	7.4 %	30,932	7.8 %	545	1.76 %
Installment/other	9,164	2.2 %	9,330	2.5 %	(166)	(1.78)%
Total Gross Loans	$422,927	100.0 %	$395,317	100.1 %	$27,610	6.98 %

The overall average yield on the loan portfolio was 5.69% for the six months ended June 30, 2014, as compared to 5.62% for the six months ended June 30, 2013. At June 30, 2014, 42.4%% of the Company's loan portfolio consisted of floating rate instruments, as compared to 42.7% of the portfolio at December 31, 2013, with the majority of those tied to the prime rate. Approximately 29.85% or $53,444,000 million of the floating rate loans have rate floors at June 30, 2014, making them effectively fixed-rate loans for certain increases in interest rates, and fixed-rate loans for all decreases in interest rates. Approximately $11,739,000 of the $53,444,000 in loans with floors have floor spreads of 100 basis points or more, meaning that interest rates would need to increase more than 1% (or 100 basis points) before the rates on those loans would increase and effectively become floating rate loans again. The portfolio of floating rate loans with floors has a relatively short duration with $13,016,000 million maturing in one year or less, and $13,968,000 maturing in less than two years.

Deposits

Total deposits were $556,065,000 at June 30, 2014, representing an increase of $13,576,000, or 2.50% from the balance of $542,489,000 reported at December 31, 2013, and an increase of $8,964,000, or 1.64% from the balance of $547,101,000 reported at June 30, 2013.

The following table sets forth the amounts of deposits outstanding by category at June 30, 2014 and December 31, 2013, and the net change between the two periods presented.

Table 6. Deposits

(In thousands)	June 30, 2014	December 31, 2013	Net Change	Percentage Change
Noninterest bearing deposits	$227,092	$214,317	$12,775	5.96 %
Interest bearing deposits:				
NOW and money market accounts	194,589	198,928	(4,339)	-2.18 %
Savings accounts	49,744	45,758	3,986	8.71 %
Time deposits:				
Under $100,000	27,022	28,825	(1,803)	-6.25 %
$100,000 and over	57,618	54,661	2,957	5.41 %
Total interest bearing deposits	328,973	328,172	801	0.24 %
Total deposits	$556,065	$542,489	$13,576	2.50 %

The Company's deposit base consists of two major components represented by noninterest bearing (demand) deposits and interest bearing deposits, totaling $227,092,000 and $328,973,000 at June 30, 2014, respectively. Interest bearing deposits consist of time certificates, NOW and money market accounts, and savings deposits. Total interest bearing deposits increased $801,000, or 0.24%, between December 31, 2013 and June 30, 2014, and noninterest bearing deposits increased $12,775,000, or 5.96% between the same two periods presented. Included in the increase of $801,000 in interest bearing deposits during the six months ended June 30, 2014, is an increase of $3,986,000 in savings accounts and an increase of $2,957,000 in time deposits of $100,000 and over.

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Core deposits, as defined by the Company as consisting of all deposits other than time deposits of $100,000 or more, and brokered deposits, continue to provide the foundation for the Company's principal sources of funding and liquidity. These core deposits amounted to 87.21% and 86.73% of the total deposit portfolio at June 30, 2014 and December 31, 2013, respectively. Brokered deposits totaled $13,514,000 at June 30, 2014, as compared to $11,500,000 at December 31, 2013, and $16,232,000 at June 30, 2013. Brokered deposits were 2.43% and 2.12% of total deposits at June 30, 2014 and December 31, 2013, respectively.

During the six months ended June 30, 2014, increases were experienced in time deposits. While total time deposits increased by $1,154,000, or 0.35%, during the six months ended June 30, 2014, brokered deposits, a component of total time deposits, increased $2,014,000, or 17.51% Although the Company will continue to use pricing strategies to control the overall level of time deposits and other borrowings as part of its balance sheet and liquidity planning process, the March 2010 agreement with the Federal Reserve Bank required reductions in brokered deposits, placing increased emphasis on core deposits as part of the Company's long-term relationship banking strategy. As a result, core deposits, including NOW and money market accounts, savings accounts, and noninterest-bearing checking accounts, continue to provide the Company's primary funding source.

On a year-to-date average, the Company experienced an increase of $13,867,000, or 2.52%, in total deposits between the six months ended June 30, 2014 and June 30, 2013. Between these two periods, average interest bearing deposits decreased $3,827,000 or 1.14%, while total noninterest-bearing deposits increased $17,694,000, or 8.24%, on a year-to-date average basis.

Short-Term Borrowings

At June 30, 2014, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling $283,153,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling $6,416,000. At June 30, 2014, the Company had an uncollateralized line of credit with Pacific Coast Bankers Bank ("PCBB") totaling $10,000,000. These lines of credit generally have interest rates tied to either the Federal Funds rate, short-term U.S. Treasury rates, or LIBOR. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. At June 30, 2014 and June 30, 2013, the Company had no outstanding borrowings. The Company had collateralized FRB lines of credit of $254,761,000, collateralized FHLB lines of credit totaling $7,094,000, and an uncollateralized lines of credit with PCBB of $10,000,000 at December 31, 2013.

Asset Quality and Allowance for Credit Losses

Lending money is the Company's principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Losses are implicit in lending activities and the amount of such losses will vary, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

As a result of the March 2010 agreement with the Federal Reserve Bank, the Company has written several plans to address the management of asset quality and the adequacy of the allowance for loan and lease losses. Specifically, the Company has three written plans which directly address these issues:

- Plan to Strengthen Credit Risk Management Practices – Includes the responsibility of the Board to establish appropriate risk tolerance guidelines and limits, timely and accurate identification and quantification of credit risk, strategies to minimize credit losses and reduce the level of problem assets, procedures for the ongoing review of the investment portfolio to evaluate other-than-temporary-impairment, stress testing for commercial real estate loans and portfolio segments, and measures to reduce the levels of other real estate owned.
-