PLUMAS BANCORP
Form 10-Q
November 07, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED September 30, 2018

TRANSITION REPORT UNDER SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM __________ TO ___________

COMMISSION FILE NUMBER: 000-49883

PLUMAS BANCORP

(Exact Name of Registrant as Specified in Its Charter)

California	**75-2987096**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
35 S. Lindan Avenue, Quincy, California	**95971**
(Address of Principal Executive Offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule12b-2 of the Exchange Act:

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 31, 2018. 5,125,476 shares.

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PLUMAS BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share data)

	September 30, 2018	**December 31, 2017**
Assets		
Cash and cash equivalents	$ 35,256	$ 87,537
Investment securities available for sale	156,734	137,466
Loans, less allowance for loan losses of $6,846 at September 30, 2018 and $6,669 at December 31, 2017	535,998	482,248
Real estate acquired through foreclosure	1,088	1,344
Premises and equipment, net	13,748	11,346
Bank owned life insurance	12,774	12,866
Accrued interest receivable and other assets	15,150	12,620
Total assets	$ 770,748	$ 745,427
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing	$ 289,859	$ 282,239
Interest bearing	392,983	380,418
Total deposits	682,842	662,657
Repurchase agreements	8,210	10,074
Accrued interest payable and other liabilities	7,020	6,686
Junior subordinated deferrable interest debentures	10,310	10,310
Total liabilities	708,382	689,727
Commitments and contingencies (Note 5)		
Shareholders' equity:		
	6,854	6,415

Common stock, no par value; 22,500,000 shares authorized; issued and outstanding – 5,125,476 shares at September 30, 2018 and 5,064,972 at December 31, 2017		
Retained earnings	59,357	49,855
Accumulated other comprehensive loss, net	(3,845)	(570)
Total shareholders’ equity	62,366	55,700
Total liabilities and shareholders’ equity	$ 770,748	$ 745,427

See notes to unaudited condensed consolidated financial statements.

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PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	**2017**	**2018**	**2017**
Interest Income:				
Interest and fees on loans	$7,693	$6,560	$21,680	$19,101
Interest on investment securities	1,037	618	2,873	1,782
Other	113	223	402	402
Total interest income	8,843	7,401	24,955	21,285
Interest Expense:				
Interest on deposits	159	149	462	429
Interest on note payable	-	-	-	28
Interest on junior subordinated deferrable interest debentures	131	103	370	295
Other	2	1	5	4
Total interest expense	292	253	837	756
Net interest income before provision for loan losses	8,551	7,148	24,118	20,529
Provision for Loan Losses	300	200	800	600
Net interest income after provision for loan losses	8,251	6,948	23,318	19,929
Non-Interest Income:				
Service charges	628	617	1,919	1,841
Interchange revenue	572	521	1,619	1,470
Gain on sale of loans	564	557	1,763	1,870
Gain on equity securities with no readily determinable fair value	-	-	209	-
Loss on sale of investments	-	-	(8)	(17)
Other	520	488	1,538	1,449
Total non-interest income	2,284	2,183	7,040	6,613
Non-Interest Expenses:				
Salaries and employee benefits	3,049	2,822	9,086	8,613
Occupancy and equipment	721	713	2,127	2,136
Other	1,658	1,597	4,893	4,357
Total non-interest expenses	5,428	5,132	16,106	15,106
Income before provision for income taxes	5,107	3,999	14,252	11,436
Provision for Income Taxes	1,411	1,551	3,830	4,383
Net income	$3,696	$2,448	$10,422	$7,053
Basic earnings per share	$0.72	$0.48	$2.04	$1.41

Diluted earnings per share	$0.71	$0.47	$2.00	$1.36

See notes to unaudited condensed consolidated financial statements.

PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	**2017**	**2018**	**2017**
Net income	$3,696	$2,448	$10,422	$7,053
Other comprehensive income:				
Change in net unrealized gain/loss	(1,285)	139	(4,657)	1,422
Reclassification adjustments for net losses included in net income	-	-	8	17
Net unrealized holding (loss) gain	(1,285)	139	(4,649)	1,439
Related tax effect:				
Change in net unrealized gain/loss	380	(57)	1,376	(586)
Reclassification of net losses included in net income	-	-	(2)	(7)
Income tax effect	380	(57)	1,374	(593)
Other comprehensive (loss) income	(905)	82	(3,275)	846
Total comprehensive income	$2,791	$2,530	$7,147	$7,899

See notes to unaudited condensed consolidated financial statements.

PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the Nine Months Ended September 30,	
	2018	**2017**
Cash Flows from Operating Activities:		
Net income	$10,422	$7,053
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	800	600
Change in deferred loan origination costs/fees, net	(1,232)	(636)
Depreciation and amortization	749	775
Stock-based compensation expense	148	122
Loss on sale of investments	8	17
Amortization of investment security premiums	518	451
Gain on equity securities with no readily determinable fair value	(209)	-
Gain on sale of OREO and other vehicles	(80)	(15)
Gain on sale of loans held for sale	(1,763)	(1,870)
Loans originated for sale	(34,289)	(27,236)
Proceeds from loan sales	37,327	31,435
Provision from change in OREO valuation	38	106
Earnings on bank-owned life insurance	(246)	(253)
Increase in accrued interest receivable and other assets	(74)	(1,081)
Increase (decrease) in accrued interest payable and other liabilities	334	(783)
Net cash provided by operating activities	12,451	8,685
Cash Flows from Investing Activities:		
Proceeds from principal repayments from available-for-sale government-sponsored mortgage-backed securities	11,349	9,387
Purchases of available-for-sale securities	(40,286)	(27,811)
Proceeds from sale of available-for-sale securities	4,157	4,221
Net increase in loans	(55,871)	(21,454)
Proceeds from Bank owned life insurance	338	-
Proceeds from sale of OREO	568	83
Proceeds from sale of other vehicles	400	171
Purchase of premises and equipment	(3,079)	(226)
Net cash used in investing activities	(82,424)	(35,629)

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PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

(Continued)

	For the Nine Months Ended September 30,	
	2018	**2017**
Cash Flows from Financing Activities:		
Net increase in demand, interest bearing and savings deposits	$26,307	$70,314
Net decrease in time deposits	(6,122)	(2,817)
Principal payment on note payable	-	(2,375)
Net (decrease) increase in securities sold under agreements to repurchase	(1,864)	1,172
Cash dividends paid on common stock	(920)	(691)
Proceeds from exercise of stock options	291	226
Net cash provided by financing activities	17,692	65,829
(Decrease) increase in cash and cash equivalents	(52,281)	38,885
Cash and Cash Equivalents at Beginning of Year	87,537	62,646
Cash and Cash Equivalents at End of Period	$35,256	$101,531
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest expense	$842	$757
Income taxes	$3,336	$5,220
Non-Cash Investing Activities:		
Real estate and vehicles acquired through foreclosure	$646	$475
Non-Cash Financing Activities:		
Common stock retired in connection with the exercise of stock options	$29	$10
Common stock issued in connection with the cashless exercise of stock warrant	$-	$787

See notes to unaudited condensed consolidated financial statements.

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PLUMAS BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. THE BUSINESS OF PLUMAS BANCORP

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

<u>Consolidation and Basis of Presentation</u>

The condensed consolidated financial statements include the accounts of the Company and the accounts of its wholly-owned subsidiary, Plumas Bank. Plumas Statutory Trust I and Plumas Statutory Trust II are not consolidated into the Company’s consolidated financial statements and, accordingly, are accounted for under the equity method. In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the Company’s financial position at September 30, 2018 and the results of its operations and its cash flows for the three-month and nine-month periods ended September 30, 2018 and 2017. Our condensed consolidated balance sheet at December 31, 2017 is derived from audited financial statements.

The unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2017 Annual Report to Shareholders on Form 10-K. The results of operations for the three-month and nine-month periods ended September 30, 2018 may not necessarily be indicative of future operating results. In preparing such financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the periods reported. Actual results could differ significantly from those estimates.

Reclassifications

Certain reclassifications have been made to prior years’ balances to conform to the classifications used in 2018. These reclassifications had no impact on the Company’s consolidated financial position, results of operations or net change in cash and cash equivalents.

Segment Information

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

Revenue from Contracts with Customers

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

Most of our revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as our loans and investment securities. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Condensed Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act (the "TCJ Act") was enacted into law. The TCJ Act provides for significant changes to the U.S. Internal Revenue Code of 1986, as amended (the "Code"), that impact corporate taxation requirements, such as the reduction of the top federal tax rate for corporations from 35% to 21% and changes or limitations to certain tax deductions. As a result of the TCJ Act, we re-measured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future. However, we are still analyzing certain aspects of the TCJ Act and refining our calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded in 2017 related to the re-measurement of our deferred tax asset was $1.4 million, and no further adjustments were made during the nine months ended September 30, 2018.

Recently Adopted Accounting Pronouncements

In February 2018, the FASB issued ASU No. 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("AOCI"). ASU No. 2018-02 allows entities to elect to reclassify stranded tax effects on items within AOCI, resulting from the new tax bill signed into law on December 22, 2017, to retained earnings. The

Company elected to early adopt this new standard in 2017 and recorded a reclassification from AOCI to retained earnings in the amount of $94,000.

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Customers (“ASU 2014-09”), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company’s consolidated financial statements and related disclosures as the Company’s primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company’s revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains/losses on the sale of loans, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

On January 5, 2016, the FASB issued ASU No. 2016-01, Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. Changes made to the current measurement model primarily affect the accounting for equity securities with readily determinable fair values, where changes in fair value will impact earnings instead of other comprehensive income. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The Update also changes the presentation and disclosure requirements for financial instruments including a requirement that public business entities use exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes. This Update is generally effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU No. 2016-01 on January 1, 2018 and recorded a $209,000 gain related to adjusting the carrying value of equity securities without a readily determinable fair market to $662,000 in accordance with this standard. Additionally, we refined the calculation used to determine the disclosed fair value of our loans held for investment as part of adopting this standard. The refined calculation did not have a significant impact on our fair value disclosures.

Pending Accounting Pronouncements

On February 25, 2016, the FASB issued ASU 2016-02, Leases. The most significant change for lessees is the requirement under the new guidance to recognize right-of-use assets and lease liabilities for all leases not considered short-term leases, which is generally defined as a lease term of less than 12 months. This change will result in lessees recognizing right-of-use assets and lease liabilities for most leases currently accounted for as operating leases under current lease accounting guidance. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018. The Company has several lease agreements, including two branch locations, which are currently considered operating leases, and therefore, not recognized on the Company's consolidated statements of condition. The Company expects the new guidance will require some of these lease agreements to now be recognized on the consolidated statements of condition as a right-of-use asset and a corresponding lease liability. The Company has performed a preliminary evaluation of the provisions of ASU No. 2016-02. Based on this evaluation, the Company has determined that ASU No. 2016-02 is not expected to have a material impact on the Company's Consolidated Financial Statements. However, the Company continues to evaluate the extent of potential impact the new guidance will have on the Company's Consolidated Balance Sheet.

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

On March 30, 2017, the FASB issued ASU 2017-08, Receivables – Non-Refundable Fees and Other Costs: Premium Amortization on Purchased Callable Debt Securities. This ASU amends the amortization period for certain purchased callable debt securities held at a premium, shortening such period to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. ASU 2017-08 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company has performed a preliminary evaluation of the provisions of ASU No. 2017-08. Based on this evaluation, the Company has determined that ASU No. 2017-08 is not expected to have a material impact on the Company's Consolidated Financial Statements.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement, Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. The amendments in this update modify the disclosure requirements for fair value measurements by removing, modifying, or adding certain disclosures. The update is effective for interim and annual periods in fiscal years beginning after December 15, 2019, with early adoption permitted. Entities are also allowed to elect early adoption of the eliminated or modified disclosure requirements and delay adoption of the new disclosure requirements until their effective date. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company's Consolidated Financial Statements.

In July 2018, the FASB issued ASU No. 2018-11, Leases - Targeted Improvements. ASU No. 2018-11 provides entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company). The Company expects to elect both transition options. ASU 2018-11 is not expected to have a material impact on the Company's Consolidated Financial Statements.

3. INVESTMENT SECURITIES AVAILABLE FOR SALE

The amortized cost and estimated fair value of investment securities at September 30, 2018 and December 31, 2017 consisted of the following, in thousands:

<u>Available-for-Sale</u>	September 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	$125,168	$ -	$ (4,498)	$120,670
Obligations of states and political subdivisions	37,024	32	(992)	36,064
	$162,192	$ 32	$ (5,490)	$156,734

Net unrealized loss on available-for-sale investment securities totaling $5,458,000 were recorded, net of $1,613,000 in tax benefit, as accumulated other comprehensive loss within shareholders' equity at September 30, 2018. During the nine months ended September 30, 2018 the Company sold eighteen available-for-sale investment securities for total proceeds of $4,157,000 recording a $8,000 loss on sale. The Company realized a gain on sale from eight of these securities totaling $4,000 and a loss on sale on ten securities of $12,000. No securities were sold during the three months ended September 30, 2018.

<u>Available-for-Sale</u>	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	$104,935	$ 26	$ (1,173)	$103,788
Obligations of states and political subdivisions	33,340	482	(144)	33,678

$138,275	$ 508	$ (1,317)	$137,466

Unrealized loss on available-for-sale investment securities totaling $809,000 were recorded, net of $239,000 in tax benefits, as accumulated other comprehensive loss within shareholders' equity at December 31, 2017. During the nine months ended September 30, 2017 the Company sold seven available-for-sale investment securities for total proceeds of $4,221,000 recording a $17,000 loss on sale. The Company realized a gain on sale from four of these securities totaling $4,000 and a loss on sale on three securities of $21,000. No securities were sold during the three months ended September 30, 2017.

There were no transfers of available-for-sale investment securities during the nine months ended September 30, 2018 and twelve months ended December 31, 2017. There were no securities classified as held-to-maturity at September 30, 2018 or December 31, 2017.

Investment securities with unrealized losses at September 30, 2018 and December 31, 2017 are summarized and classified according to the duration of the loss period as follows, in thousands:

September 30, 2018	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
U.S. Government-sponsored agencies collateralized by mortgage obligations-residential	$75,524	$ 2,103	$45,146	$ 2,395	$120,670	$ 4,498
Obligations of states and political subdivisions	27,704	632	4,697	360	32,401	992
	$103,228	$ 2,735	$49,843	$ 2,755	$153,071	$ 5,490

December 31, 2017	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
U.S. Government-sponsored agencies collateralized by mortgage obligations-residential	$60,070	$ 441	$31,213	$ 732	$91,283	$ 1,173
Obligations of states and political subdivisions	2,621	31	3,403	113	6,024	144
	$62,691	$ 472	$34,616	$ 845	$97,307	$ 1,317

At September 30, 2018, the Company held 203 securities of which 188 were in a loss position. Of the securities in a loss position, 126 were in a loss position for less than twelve months. Of the 203 securities 89 are U.S. Government-sponsored agencies collateralized by residential mortgage obligations and 114 were obligations of states and political subdivisions. The unrealized losses relate principally to market rate conditions. All the securities continue to pay as scheduled. When analyzing an issuer's financial condition, management considers the length of time and extent to which the market value has been less than cost; the historical and implied volatility of the security; the financial condition of the issuer of the security; and the Company's intent and ability to hold the security to recovery. As of September 30, 2018, management does not have the intent to sell these securities nor does it believe it is more likely than not that it will be required to sell these securities before the recovery of its amortized cost basis. Based on the Company's evaluation of the above and other relevant factors, the Company does not believe the securities that are in an unrealized loss position as of September 30, 2018 are other than temporarily impaired.

The amortized cost and estimated fair value of investment securities at September 30, 2018 by contractual maturity are shown below, in thousands.

	Amortized Cost	Estimated Fair

		Value
Within one year	$ -	$ -
After one year through five years	3,060	3,029
After five years through ten years	17,299	16,906
After ten years	16,665	16,129
Investment securities not due at a single maturity date:		
Government-sponsored mortgage-backed securities	125,168	120,670
	$ 162,192	$ 156,734

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

Investment securities with amortized costs totaling $87,579,000 and $82,059,000 and estimated fair values totaling $84,152,000 and $81,006,000 at September 30, 2018 and December 31, 2017, respectively, were pledged to secure deposits and repurchase agreements.

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES

Outstanding loans are summarized below, in thousands:

	September 30, 2018	December 31, 2017
Commercial	$ 46,762	$ 39,620
Agricultural	70,917	58,908
Real estate – residential	15,674	16,624
Real estate – commercial	253,154	240,257
Real estate – construction and land development	38,454	25,181
Equity lines of credit	39,165	41,798
Auto	71,875	60,438
Other	3,846	3,808
Total loans	539,847	486,634
Deferred loan costs, net	2,997	2,283
Allowance for loan losses	(6,846)	(6,669)
Total net loans	$ 535,998	$ 482,248

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

	September 30, 2018	December 31, 2017
Balance, beginning of year	$ 6,669	$ 6,549
Provision charged to operations	800	600
Losses charged to allowance	(988)	(879)
Recoveries	365	399
Balance, end of period	$ 6,846	$ 6,669

The recorded investment in impaired loans totaled $2,332,000 and $2,270,000 at September 30, 2018 and December 31, 2017, respectively. The Company had specific allowances for loan losses of $79,000 on impaired loans of $554,000 at September 30, 2018 as compared to specific allowances for loan losses of $82,000 on impaired loans of $475,000 at December 31, 2017. The balance of impaired loans in which no specific reserves were required totaled $1,778,000 and $1,795,000 at September 30, 2018 and December 31, 2017, respectively. The average recorded investment in impaired loans for the nine months ended September 30, 2018 and September 30, 2017 was $1,738,000 and $4,982,000, respectively. The Company recognized $56,000 and $100,000 in interest income for impaired loans during the nine months ended September 30, 2018 and 2017, respectively. No interest was recognized on nonaccrual loans accounted for on a cash basis during the nine months ended September 30, 2018 and 2017.

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

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

The carrying value of troubled debt restructurings at September 30, 2018 and December 31, 2017 was $1,089,000 and $1,111,000, respectively. The Company has allocated $54,000 and $63,000 of specific reserves on loans to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2018 and December 31, 2017. The Company has not committed to lend additional amounts on loans classified as troubled debt restructurings at September 30, 2018 and December 31, 2017.

There were no troubled debt restructurings that occurred during the nine months ending September 30, 2018 or September 30, 2017. There were no troubled debt restructurings for which there was a payment default within twelve months following the modification during the nine months ended September 30, 2018 and 2017, respectively.

At September 30, 2018 and December 31, 2017, nonaccrual loans totaled $1,244,000 and $1,226,000, respectively. Interest foregone on nonaccrual loans totaled $36,000 and $141,000 for the nine months ended September 30, 2018 and 2017, respectively. Interest foregone on nonaccrual loans totaled $7,000 and $52,000 for the three months ended September 30, 2018 and 2017, respectively. At December 31, 2017 there were three loans to one customer totaling $1.8 million that were 90 days past due and still accruing interest. These loans were well secured and in process of collection at December 31, 2017. The Company has received payment, in full, of principal and interest on these loans.

Salaries and employee benefits totaling $1,937,000 and $1,393,000 have been deferred as loan origination costs during the nine months ended September 30, 2018 and 2017, respectively. Salaries and employee benefits totaling $703,000 and $457,000 have been deferred as loan origination costs during the three months ended September 30, 2018 and 2017, respectively.

The Company assigns a risk rating to all loans and periodically, but not less than annually, performs detailed reviews of all criticized and classified loans over $100,000 to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Company and the Company’s regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan.

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

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

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

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

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass-rated loans.

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

September 30, 2018 **Commercial Credit Exposure**
Credit Risk Profile by Internally Assigned Grade

Grade:	Commercial	Agricultural	Real Estate- Residential	Real Estate- Commercial	Real Estate- Construction	Equity LOC	Total
Pass	$46,184	$ 70,664	$ 15,260	$ 249,576	$ 38,360	$38,724	$458,768
Special Mention	544	253	120	3,447	-	-	4,364
Substandard	34	-	294	131	94	441	994
Doubtful	-	-	-	-	-	-	-
Total	$46,762	$ 70,917	$ 15,674	$ 253,154	$ 38,454	$39,165	$464,126

December 31, 2017 **Commercial Credit Exposure**
Credit Risk Profile by Internally Assigned Grade

Grade:	Commercial	Agricultural	Real Estate- Residential	Real Estate- Commercial	Real Estate- Construction	Equity LOC	Total
Pass	$38,851	$ 56,859	$ 16,218	$ 239,944	$ 25,081	$41,636	$418,589
Special Mention	238	253	125	26	-	-	642
Substandard	531	1,796	281	287	100	162	3,157
Doubtful	-	-	-	-	-	-	-
Total	$39,620	$ 58,908	$ 16,624	$ 240,257	$ 25,181	$41,798	$422,388

	Consumer Credit Exposure Credit Risk Profile Based on Payment Activity September 30, 2018			**Consumer Credit Exposure Credit Risk Profile Based on Payment Activity December 31, 2017**		
	Auto	Other	Total	Auto	Other	Total

Grade:						
Performing	$71,596	$3,841	$75,437	$60,060	$3,788	$63,848
Non-performing	279	5	284	378	20	398
Total	$71,875	$3,846	$75,721	$60,438	$3,808	$64,246

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

Nine months ended 9/30/18:	Commercial	Agricultural	Real Estate- Residential	Real Estate- Commercial	Real Estate- Construction	Equity LOC	Auto	Other	Total
Allowance for Loan Losses									
Beginning balance	$ 725	$ 623	$ 231	$ 2,729	$ 783	$ 533	$ 946	$ 99	$ 6,669
Charge-offs	(325)	-	-	-	-	-	(628)	(35)	(988)
Recoveries	23	-	93	19	3	4	213	10	365
Provision	345	(26)	(124)	(124)	122	(48)	635	20	800
Ending balance	$ 768	$ 597	$ 200	$ 2,624	$ 908	$ 489	$ 1,166	$ 94	$ 6,846
Three months ended 9/30/18:									
Allowance for Loan Losses									
Beginning balance	$ 853	$ 546	$ 195	$ 2,699	$ 780	$ 481	$ 1,044	$ 100	$ 6,698
Charge-offs	(59)	-	-	-	-	-	(152)	(14)	(225)
Recoveries	8	-	2	1	1	1	58	2	73
Provision	(34)	51	3	(76)	127	7	216	6	300
Ending balance	$ 768	$ 597	$ 200	$ 2,624	$ 908	$ 489	$ 1,166	$ 94	$ 6,846
Nine months ended 9/30/17:									
Allowance for Loan Losses									
Beginning balance	$ 655	$ 466	$ 280	$ 2,740	$ 927	$ 575	$ 815	$ 91	$ 6,549
Charge-offs	(179)	-	-	-	-	(5)	(295)	(35)	(514)
Recoveries	46	-	3	4	-	3	123	8	187
Provision	108	95	(47)	39	64	77	233	31	600
Ending balance	$ 630	$ 561	$ 236	$ 2,783	$ 991	$ 650	$ 876	$ 95	$ 6,822
Three months ended 9/30/17:									
Allowance for Loan Losses									
Beginning balance	$ 705	$ 514	$ 252	$ 2,812	$ 1,071	$ 561	$ 845	$ 95	$ 6,855
Charge-offs	(112)	-	-	-	-	(5)	(205)	(17)	(339)
Recoveries	27	-	1	1	-	1	73	3	106
Provision	10	47	(17)	(30)	(80)	93	163	14	200
Ending balance	$ 630	$ 561	$ 236	$ 2,783	$ 991	$ 650	$ 876	$ 95	$ 6,822

September 30, 2018:									
Allowance for Loan Losses									
Ending balance: individually evaluated for impairment	$ -	$ -	$ 42	$ -	$ 12	$25	$-	$-	$79
Ending balance: collectively evaluated for impairment	$ 768	$ 597	$ 158	$ 2,624	$ 896	$464	$1,166	$94	$6,767
Loans									
Ending balance	$ 46,762	$ 70,917	$ 15,674	$ 253,154	$ 38,454	$39,165	$71,875	$3,846	$539,847
Ending balance: individually evaluated for impairment	$ 14	$ 253	$ 997	$ 131	$ 213	$441	$279	$4	$2,332
Ending balance: collectively evaluated for impairment	$ 46,748	$ 70,664	$ 14,677	$ 253,023	$ 38,241	$38,724	$71,596	$3,842	$537,515
December 31, 2017:									
Allowance for Loan Losses									
Ending balance: individually evaluated for impairment	$ 2	$ -	$ 48	$ -	$ 32	$-	$-	$-	$82
Ending balance: collectively evaluated for impairment	$ 723	$ 623	$ 183	$ 2,729	$ 751	$533	$946	$99	$6,587
Loans									
Ending balance	$ 39,620	$ 58,908	$ 16,624	$ 240,257	$ 25,181	$41,798	$60,438	$3,808	$486,634
Ending balance: individually evaluated for impairment	$ 14	$ 253	$ 934	$ 287	$ 224	$162	$377	$19	$2,270
Ending balance: collectively evaluated for impairment	$ 39,606	$ 58,655	$ 15,690	$ 239,970	$ 24,957	$41,636	$60,061	$3,789	$484,364

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

September 30, 2018	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due and Nonaccrual	Current	Total
Commercial	$16	$ -	$ -	$ 16	$46,746	$46,762
Agricultural	647	-	-	647	70,270	70,917
Real estate – residential	157	-	294	451	15,223	15,674
Real estate – commercial	-	-	131	131	253,023	253,154
Real estate - construction & land	-	-	94	94	38,360	38,454
Equity Lines of Credit	227	-	441	668	38,497	39,165
Auto	1,128	-	280	1,408	70,467	71,875
Other	25	-	4	29	3,817	3,846
Total	$2,200	$ -	$ 1,244	$ 3,444	$536,403	$539,847

December 31, 2017	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due and Nonaccrual	Current	Total
Commercial	$1,869	$ -	$ -	$ 1,869	$37,751	$39,620
Agricultural	-	1,796	-	1,796	57,112	58,908
Real estate – residential	130	-	281	411	16,213	16,624
Real estate - commercial	-	-	287	287	239,970	240,257
Real estate - construction & land	38	-	100	138	25,043	25,181
Equity Lines of Credit	345	-	162	507	41,291	41,798
Auto	1,047	-	377	1,424	59,014	60,438
Other	20	-	19	39	3,769	3,808
Total	$3,449	$ 1,796	$ 1,226	$ 6,471	$480,163	$486,634

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

As of September 30, 2018:	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 14	$ 14		$ 14	$ 1
Agricultural	253	264		253	14
Real estate – residential	817	817		688	30
Real estate – commercial	131	131		136	-
Real estate – construction & land	94	94		97	-
Equity Lines of Credit	186	186		48	-
Auto	279	279		196	-
Other	4	4		1	-
With an allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Agricultural	-	-	-	-	-
Real estate – residential	180	180	42	181	5
Real estate – commercial	-	-	-	-	-
Real estate – construction & land	119	119	12	121	6
Equity Lines of Credit	255	255	25	3	-
Auto	-	-	-	-	-
Other	-	-	-	-	-
Total:					
Commercial	$ 14	$ 14	$ -	$ 14	$ 1
Agricultural	253	264	-	253	14
Real estate – residential	997	997	42	869	35
Real estate – commercial	131	131	-	136	-
Real estate – construction & land	213	213	12	218	6
Equity Lines of Credit	441	441	25	51	-
Auto	279	279	-	196	-
Other	4	4	-	1	-
Total	$ 2,332	$ 2,343	$ 79	$ 1,738	$ 56

As of December 31, 2017:	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ -	$ -		$ -	$ -
Agricultural	253	253		255	19
Real estate – residential	697	708		548	38
Real estate – commercial	287	287		184	-
Real estate – construction & land	-	-		-	-
Equity Lines of Credit	162	162		180	-
Auto	377	377		144	-
Other	19	19		1	-
With an allowance recorded:					
Commercial	$ 14	$ 14	$ 2	$ 15	$ 1
Agricultural	-	-	-	-	-
Real estate – residential	237	237	48	203	7
Real estate – commercial	-	-	-	-	-
Real estate – construction & land	224	224	32	230	8
Equity Lines of Credit	-	-	-	-	-
Auto	-	-	-	-	-
Other	-	-	-	-	-
Total:					
Commercial	$ 14	$ 14	$ 2	$ 15	$ 1
Agricultural	253	253	-	255	19
Real estate – residential	934	945	48	751	45
Real estate – commercial	287	287	-	184	-
Real estate – construction & land	224	224	32	230	8
Equity Lines of Credit	162	162	-	180	-
Auto	377	377	-	144	-
Other	19	19	-	1	-
Total	$ 2,270	$ 2,281	$ 82	$ 1,760	$ 73

5. COMMITMENTS AND CONTINGENCIES

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

In the normal course of business, there are various outstanding commitments to extend credit, which are not reflected in the financial statements, including loan commitments of $131.2 million and $107.4 million and stand-by letters of credit of $417 thousand and $477 thousand at September 30, 2018 and December 31, 2017, respectively.

Of the loan commitments outstanding at September 30, 2018, $37.7 million are real estate construction loan commitments that are expected to fund within the next twelve months. The remaining commitments primarily relate to revolving lines of credit or other commercial loans, and many of these are expected to expire without being drawn upon. Therefore, the total commitments do not necessarily represent future cash requirements. Each loan commitment and the amount and type of collateral obtained, if any, are evaluated on an individual basis. Collateral held varies, but may include real property, bank deposits, debt or equity securities or business assets.

Stand-by letters of credit are conditional commitments written to guarantee the performance of a customer to a third party. These guarantees are primarily related to the purchases of inventory by commercial customers and are typically short-term in nature. Credit risk is similar to that involved in extending loan commitments to customers and accordingly, evaluation and collateral requirements similar to those for loan commitments are used. The deferred liability related to the Company's stand-by letters of credit was not significant at September 30, 2018 or December 31, 2017.

6. EARNINGS PER SHARE

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

(In thousands, except per share data)	For the Three Months Ended September 30, 2018	2017	For the Nine Months Ended September 30, 2018	2017
Net Income:				
Net income	$3,696	$2,448	$10,422	$7,053
Earnings Per Share:				
Basic earnings per share	$0.72	$0.48	$2.04	$1.41
Diluted earnings per share	$0.71	$0.47	$2.00	$1.36
Weighted Average Number of Shares Outstanding:				
Basic shares	5,122	5,048	5,100	4,987
Diluted shares	5,225	5,192	5,219	5,181

Shares of common stock issuable under stock options for which the exercise prices were greater than the average market prices were not included in the computation of diluted earnings per share due to their antidilutive effect. Stock options not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 71,000 and 0 for the three-month periods ended September 30, 2018 and 2017, respectively. Stock options not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 71,000 and 0 for the nine-month periods ended September 30, 2018 and 2017, respectively.

7. STOCK-BASED COMPENSATION

Stock Options

In 2001, the Company established a Stock Option Plan for which 16,793 shares of common stock remain reserved for issuance to employees and directors and no shares are available for future grants as of September 30, 2018.

As of September 30, 2018, all remaining shares in this plan have vested and no compensation cost remains unrecognized.

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

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Intrinsic Value
Options outstanding at January 1, 2018	46,293	$ 2.95		
Options exercised	(29,500)	2.95		
Options outstanding at September 30, 2018	16,793	$ 2.95	0.5	$368,000
Options exercisable at September 30, 2018	16,793	$ 2.95	0.5	$368,000

In May 2013, the Company established the 2013 Stock Option Plan for which 434,000 shares of common stock are reserved and 236,100 shares are available for future grants as of September 30, 2018. The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised. Payment in full for the option price must be made in cash, with Company common stock previously acquired by the optionee and held by the optionee for a period of at least six months, in options of the Optionee that are fully vested and exercisable or in any combination of the foregoing. The options expire on dates determined by the Board of Directors, but not later than ten years from the date of grant.

During the nine months ended September 30, 2018 the Company granted options to purchase 76,000 shares of common stock. The fair value of each option was estimated on the date of grant using the following assumptions. No options were granted during the nine months ended September 30, 2017. The fair value of each option was estimated on the date of grant using the following assumptions.

	2018
Expected life of stock options (in years)	5.1
Risk free interest rate	2.38%
Volatility	30.4%
Dividend yields	1.39%
Weighted-average fair value of options granted during the nine months ended September 30, 2018	$6.54

The Company determines the fair value of options on the date of grant using a Black-Scholes-Merton option pricing model that uses assumptions based on expected option life, expected stock volatility and the risk-free interest rate. The expected volatility assumptions used by the Company are based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options. The Company bases its expected life assumption on its historical experience and on the terms and conditions of the stock options it grants to employees. The risk-free rate is based on the U.S. Treasury yield curve for the periods within the contractual life of the options in effect at the time of the grant.

A summary of the activity within the 2013 Plan follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Intrinsic Value
Options outstanding at January 1, 2018	160,600	$ 7.72		
Options granted	76,000	24.40		
Options cancelled	(6,500)	20.55		
Options exercised	(32,200)	7.23		
Options outstanding at September 30, 2018	197,900	$ 13.79	5.7	$2,189,000
Options exercisable at September 30, 2018	81,200	$ 7.33	4.3	$1,423,000
Expected to vest after September 30, 2018	103,583	$ 18.28	6.6	$680,000

As of September 30, 2018, there was $506,000 of total unrecognized compensation cost related to non-vested, share-based compensation. That cost is expected to be recognized over a weighted average period of 2.7 years.

The total fair value of options vested during the nine months ended September 30, 2018 and 2017 was $150,000 and $161,000, respectively. The total intrinsic value of options at time of exercise under the two plans was $1,261,000 and $674,000 for the nine months ended September 30, 2018 and 2017, respectively.

Compensation cost related to stock options recognized in operating results under the stock option plans was $148,000 and $122,000 for the nine months ended September 30, 2018 and 2017, respectively. The associated income tax benefit recognized was $10,000 for the nine months ended September 30, 2018 and $11,000 for the nine months ended September 30, 2017. Compensation cost related to stock options recognized in operating results under the stock option plans was $50,000 and $35,000 for the three months ended September 30, 2018 and 2017, respectively. The associated income tax benefit recognized was $3,000 for the three months ended September 30, 2018 and $4,000 for the three months ended September 30, 2017.

Cash received from option exercises under the plans for the nine months ended September 30, 2018 and 2017 were $291,000 and $226,000, respectively. The tax benefit realized for the tax deductions from option exercise totaled $99,000 and $52,000 for the nine months ended September 30, 2018 and 2017, respectively.

8. INCOME TAXES

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

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

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the consolidated income statement. There have been no significant changes to unrecognized tax benefits or accrued interest and penalties for the three months ended September 30, 2018.

9. FAIR VALUE MEASUREMENT

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

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

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

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

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

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

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

The methods of determining the fair value of assets and liabilities presented in this note as of September 30, 2018 are consistent with Note 3 of the Company's 2017 Form 10-K except for the valuation of loans held for investment at September 30, 2018. We refined the calculation used to determine the disclosed fair value of our loans held for investment to estimate the fair value of our loan portfolio based on an exit price concept as part of adopting ASU 2016-01.

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at September 30, 2018 follows, in thousands:

		Fair Value Measurements at September 30, 2018 Using:			
	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$35,256	$35,256			$35,256
Investment securities	156,734		$156,734		156,734
Loans, net	535,998			$540,632	540,632
FHLB stock	3,027				N/A
Accrued interest receivable	2,888	3	573	2,312	2,888
Financial liabilities:					
Deposits	682,842	642,924	39,883		682,807
Repurchase agreements	8,210		8,210		8,210
Junior subordinated deferrable interest debentures	10,310			7,744	7,744
Accrued interest payable	59	10	34	15	59

The carrying amounts and estimated fair values of financial instruments, at December 31, 2017 follows, in thousands:

	Carrying Value	Fair Value Measurements at December 31, 2017 Using: Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$87,537	$87,537			$87,537
Investment securities	137,466		$137,466		137,466
Loans, net	482,248			$484,269	484,269
FHLB stock	2,685				N/A
Accrued interest receivable	2,582	31	522	2,029	2,582
Financial liabilities:					
Deposits	662,657	616,617	46,061		662,678
Repurchase agreements	10,074		10,074		10,074
Junior subordinated deferrable interest debentures	10,310			7,829	7,829
Accrued interest payable	64	10	39	15	64

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

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

The following tables present information about the Company’s assets and liabilities measured at fair value on a recurring and non-recurring basis as of September 30, 2018 and December 31, 2017, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

Assets and liabilities measured at fair value on a recurring basis at September 30, 2018 are summarized below, in thousands:

	Fair Value Measurements at September 30, 2018 Using			
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	$ 120,670	$ -	$ 120,670	$ -
Obligations of states and political subdivisions	36,064		36,064	
	$ 156,734	$ -	$ 156,734	$ -

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Assets and liabilities measured at fair value on a recurring basis at December 31, 2017 are summarized below, in thousands:

		Fair Value Measurements at December 31, 2017 Using		
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	$103,788	$-	$ 103,788	$ -
Obligations of states and political subdivisions	33,678		33,678	
	$137,466	$-	$ 137,466	$ -

The fair value of securities available-for-sale equals quoted market price, if available. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities or matrix pricing. There were no changes in the valuation techniques used during 2018 or 2017. Transfers between hierarchy measurement levels are recognized by the Company as of the beginning of the reporting period. Changes in fair market value are recorded in other comprehensive income.

Assets and liabilities measured at fair value on a non-recurring basis at September 30, 2018 are summarized below, in thousands:

	Total Fair Value	Fair Value Measurements at September 30, 2018 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses) Nine Months Ended September 30, 2018
Assets:					
Impaired loans:					
Equity lines of credit	$231	$-	$ -	$ 231	$ (25)
Total impaired loans	$231	$-	$ -	$ 231	$ (25)
Other real estate:					
Real estate – residential	76	-	-	76	(38)
Real estate – commercial	440	-	-	440	-
Construction and land	572	-	-	572	-
Total other real estate	1,088	-	-	1,088	(38)
	$1,319	$-	$ -	$ 1,319	$ (63)

Assets and liabilities measured at fair value on a non-recurring basis at December 31, 2017 are summarized below, in thousands:

		Fair Value Measurements at December 31, 2017 Using			
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) Nine Months Ended September 30, 2017
Assets:					
Impaired loans:					
Real estate – commercial	$-	$-	$ -	$ -	$ 7
Construction and land	80	-	-	80	-
Equity lines of credit	-	-	-	-	(115)
Total impaired loans	80	-	-	80	(108)
Other real estate:					
Real estate – residential	-	-	-	-	(2)
Real estate – commercial	285	-	-	285	(9)
Construction and land	969	-	-	969	(95)
Equity lines of credit	90	-	-	90	-
Total other real estate	1,344	-	-	1,344	(106)
	$1,424	$-	$ -	$ 1,424	$ (214)

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

The following methods were used to estimate fair value.

<u>Collateral-Dependent Impaired Loans:</u> The Bank does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect partial write-downs, through

charge-offs or specific reserve allowances, that are based on fair value estimates of the underlying collateral. The fair value estimates for collateral-dependent impaired loans are generally based on recent real estate appraisals or broker opinions, obtained from independent third parties, which are frequently adjusted by management to reflect current conditions and estimated selling costs (Level 3). Net (losses) of $(25,000) and $(108,000) represent changes in impairment charges recognized during the nine-months ended September 30, 2018 and 2017, respectively, related to the above impaired loans.

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

Appraisals for both collateral-dependent impaired loans and other real estate are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Loan Administration Department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Company compares the actual selling price of similar collateral that has been liquidated to the most recent appraised value for unsold properties to determine what additional adjustment, if any, should be made to the appraisal value to arrive at fair value. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2018 and December 31, 2017 (dollars in thousands):

Description	Fair Value 9/30/2018	Fair Value 12/31/2017	Valuation Technique	Significant Unobservable Input	Range (Weighted Average) 9/30/2018	Range (Weighted Average) 12/31/2017
<u>Impaired Loans:</u>						
Construction and land	$ -	$ 80	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs		8% (8%)
Equity Lines of Credit	231	-	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs	10% (10%)	N/A
<u>Other Real Estate:</u>						
RE – Residential	$ 76	$ -	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs	10% (10%)	N/A
RE – Commercial	$ 440	$ 285	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs	16%- 29% (19%)	17%- 31% (22%)
Construction and land	$ 572	$ 969	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs	10% (10%)	10% (10%)
Equity Lines of Credit	$ -	$ 90	Third Party appraisals	Management Adjustments to Reflect Current Conditions and Selling Costs	10% (10%)	10% (10%)

PART I – FINANCIAL INFORMATION

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

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

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

INTRODUCTION

The following discussion and analysis sets forth certain statistical information relating to the Company as of September 30, 2018 and December 31, 2017 and for the nine and three-month periods ended September 30, 2018 and 2017. This discussion should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and the consolidated financial statements and notes thereto included in Plumas Bancorp’s Annual Report filed on Form 10-K for the year ended December 31, 2017.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

There have been no changes to the Company’s critical accounting policies from those disclosed in the Company’s 2017 Annual Report to Shareholders on Form 10-K.

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

OVERVIEW - NINE MONTHS ENDED SEPTEMBER 30, 2018

Net income increased by $3.4 million from $7.0 million during the nine months ended September 30, 2017 to $10.4 million during the current nine-month period. Earnings benefited from increases of $3.6 million in net interest income and $427 thousand in non-interest income and a decrease of $553 thousand in income tax expense. These items were partially offset by increases of $1 million in non-interest expense and $200 thousand in the provision for loan losses. Diluted earnings per share increased to $2.00 for the nine months ended September 30, 2018 compared to $1.36 during the nine months ended September 30, 2017.

Total assets at September 30, 2018 were $771 million, an increase of $25.3 million from December 31, 2017. Net loans increased by $53.8 million from $482.2 million at December 31, 2017 to $536.0 million at September 30, 2018. Investment securities increased by $19.2 million from $137.5 million at December 31, 2017 to $156.7 million at September 30, 2018. Cash and cash equivalents totaled $35.3 million at September 30, 2018 down $52.2 million from $87.5 million at December 31, 2017.

Deposits totaled $683 million at September 30, 2018, an increase of $20.2 million from $663 million at December 31, 2017. Non-interest-bearing demand deposits increased by $7.6 million, NOW accounts increased by $5.2 million and savings and money market accounts increased by $13.5 million. These increases were partially offset by a decline of $6.1 million in time deposits.

Shareholders' equity increased by $6.7 million from $55.7 million at December 31, 2017 to $62.4 million at September 30, 2018.

The annualized return on average assets was 1.87% for the nine months ended September 30, 2018 up from 1.39% for the nine months ended September 30, 2017. The annualized return on average equity increased from 18.1% during the first nine months of 2017 to 23.7% during the current nine-month period.

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

RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018

Net interest income before provision for loan losses. Net interest income, on a nontax-equivalent basis, for the nine months ended September 30, 2018 was $24.1 million, an increase of $3.6 million from the $20.5 million earned during the same period in 2017. The increase in net interest income includes an increase of $3.7 million in interest income partially offset by an increase of $81 thousand in interest expense. Net interest margin, which benefited from a 32 basis points increase in average yield on interest-earning assets, increased 31 basis points to 4.68%, up from 4.37% for the same period in 2017.

Interest income increased by 17% to $25.0 million for the nine months ended September 30, 2018, up from $21.3 million during the same period in 2017. Related to increases in average loan balances and loan yield, interest and fees on loans increased by $2.6 million to $21.7 million for the nine months ended September 30, 2018; compared to $19.1 million during the comparable period in 2017. The Company's average loan balances were $507 million for the nine months ended September 30, 2018, up $38 million, or 8%, from $469 million for the same period in 2017.

The following table compares loan balances by type at September 30, 2018 and 2017.

(dollars in thousands)	Balance at End of Period 09/30/18	Percent of Loans in Each Category to Total Loans 09/30/18		Balance at End of Period 09/30/17	Percent of Loans in Each Category to Total Loans 09/30/17	
Commercial	$46,762	8.7	%	$40,211	8.4	%
Agricultural	70,917	13.1	%	58,105	12.1	%
Real estate – residential	15,674	2.9	%	17,810	3.7	%
Real estate – commercial	253,154	46.9	%	236,913	49.4	%
Real estate – construction	38,454	7.1	%	23,175	4.8	%
Equity Lines of Credit	39,165	7.3	%	41,926	8.8	%
Auto	71,875	13.3	%	57,446	12.0	%
Other	3,846	0.7	%	3,697	0.8	%
Total Gross Loans	$539,847	100	%	$479,283	100	%

The average rate earned on the Company's loan balances increased by 27 basis points to 5.72% during the first nine months of 2018 compared to 5.45% during the first nine months of 2017. We attribute this increase in yield primarily to an increase in the prime interest rate and additionally to a decrease in net loan costs of $103 thousand. Loan pricing continues to be extremely competitive in our service area.

Interest on investment securities increased by $1.1 million related to an increase in yield of 41 basis points, from 2.15% during the nine months ended September 30, 2017 to 2.56% during the current nine-month period, and an increase in average balance from $110.9 million during the 2017 period to $150.3 million during the nine months ended September 30, 2018. We attribute the increase in yield during the current period primarily to market conditions. See "Investment Portfolio and Federal Funds Sold" for additional information related to the Company's investment portfolio. Interest earned on other interest earning assets totaled $402 thousand in both periods as a decrease in average balance of $16.6 million was offset by an increase in yield of 59 basis points from 1.11% during the nine months ended September 30, 2017 to 1.70% during the current nine-month period. Other interest earning assets mostly related to balances held at the Federal Reserve Bank of San Francisco and the increase in yield is consistent with the increase in the average federal funds rate during the periods.

Interest expense on deposits increased by $33 thousand to $462 thousand for the nine months ended September 30, 2018, up from $429 thousand during the 2017 period. This increase relates to an increase in the average balance of NOW, Money Market and Savings accounts partially offset by a decrease in the average balance of time deposits.

The largest increase in interest expense on deposits was a $26 thousand increase in interest on savings accounts related to growth in this deposit category. Average savings balances increased from $155.5 million during the nine months ended September 30, 2017 to $175.7 million during the current nine-month period. Plumas Bank's savings accounts provide an attractive interest rate, in the current rate environment, and we have seen continued growth in savings accounts for the last few years. The average rate paid on savings accounts was 17 basis points during the nine months ended September 30, 2018 and 2017.

Interest on time deposits declined by $10 thousand. Average time deposits declined by $5.5 million from $47.6 million during the nine months ended September 30, 2017 to $42.1 million during the current period. We attribute much of the reduction in time deposit to the unusually low interest rate environment as we have seen a movement out of time into more liquid deposit types. The average rate paid on time deposits was 0.31% during the nine months ended September 30, 2018 and 2017.

Interest expense on other interest-bearing liabilities increased by $48 thousand from $327 thousand during the nine months ended September 30, 2017 to $375 thousand during the current nine-month period. Interest expense on note payable was $28 thousand during the nine months ended September 30, 2017. The note payable was paid off in April of 2017 resulting in a decrease in expense in the comparison periods of $28 thousand. Interest expense on junior subordinated debentures, which increased by $75 thousand to $370 thousand, fluctuates with changes in the 3-month London Interbank Offered Rate (LIBOR).

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

	For the Nine Months Ended September 30, 2018			**For the Nine Months Ended September 30, 2017**		
	Average Balance (in thousands)	**Interest (in thousands)**	**Yield/ Rate**	**Average Balance (in thousands)**	**Interest (in thousands)**	**Yield/ Rate**
Interest-earning assets:						
Loans (1) (2) (3)	$506,592	$ 21,680	5.72 %	$468,731	$ 19,101	5.45 %
Investment securities (1)	150,285	2,873	2.56 %	110,944	1,782	2.15 %
Interest-bearing deposits	31,581	402	1.70 %	48,218	402	1.11 %
Total interest-earning assets	688,458	24,955	4.85 %	627,893	21,285	4.53 %
Cash and due from banks	21,306			18,994		
Other assets	37,323			32,723		
Total assets	$747,087			$679,610		
Interest-bearing liabilities:						
NOW deposits	$102,939	72	0.09 %	$95,791	66	0.09 %
Money market deposits	66,557	73	0.15 %	57,303	62	0.14 %
Savings deposits	175,739	218	0.17 %	155,521	192	0.17 %
Time deposits	42,098	99	0.31 %	47,619	109	0.31 %
Total deposits	387,333	462	0.16 %	356,234	429	0.16 %
Note payable	-	-	- %	936	28	4.00 %
Junior subordinated debentures	10,310	370	4.80 %	10,310	295	3.83 %
Other interest-bearing liabilities	7,935	5	0.08 %	6,733	4	0.08 %
Total interest-bearing liabilities	405,578	837	0.28 %	374,213	756	0.27 %
Non-interest-bearing deposits	275,953			246,923		
Other liabilities	6,704			6,326		
Shareholders' equity	58,852			52,148		
Total liabilities & equity	$747,087			$679,610		

Cost of funding interest-earning assets (4)		0.17 %		0.16 %
Net interest income and margin (5)	$ 24,118	4.68 %	$ 20,529	4.37 %

(1) Not computed on a tax-equivalent basis.
(2) Average nonaccrual loan balances of $1.0 million for 2018 and $3.1 million for 2017 are included in average loan balances for computational purposes.
(3) Net loan costs included in loan interest income for the nine-month periods ended September 30, 2018 and 2017 were $247,000 and $350,000, respectively.
(4) Total annualized interest expense divided by the average balance of total earning assets.
(5) Annualized net interest income divided by the average balance of total earning assets.

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

	2018 over 2017 change in net interest income for the nine months ended September 30 (in thousands)			
	Volume (1)	**Rate (2)**	**Mix (3)**	**Total**
Interest-earning assets:				
Loans	$1,543	$959	$77	$2,579
Investment securities	632	339	120	1,091
Interest bearing deposits	(139)	212	(73)	-
Total interest income	2,036	1,510	124	3,670
Interest-bearing liabilities:				
NOW deposits	5	1	-	6
Money market deposits	10	1	-	11
Savings deposits	25	1	-	26
Time deposits	(13)	3	-	(10)
Note payable	(28)	-	-	(28)
Junior subordinated debentures	-	75	-	75
Other	1	-	-	1
Total interest expense	-	81	-	81
Net interest income	$2,036	$1,429	$124	$3,589

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

Provision for loan losses. During the nine months ended September 30, 2018 and 2017 we recorded a provision for loan losses of $800 thousand and $600 thousand, respectively. See "Analysis of Asset Quality and Allowance for Loan Losses" for further discussion of loan quality trends and the provision for loan losses.

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

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

Non-interest income. During the nine months ended September 30, 2018, non-interest income totaled $7.0 million, an increase of $427 thousand from the nine months ended September 30, 2017. The largest component of this increase was a $209 thousand gain recorded upon the prospective adoption of a newly effective accounting pronouncement impacting the measurement of equity securities, which in our case consists of stock in our correspondent banks, without a readily determinable fair market value. Other significant increases included $78 thousand in service charges on deposit accounts, $149 thousand in interchange income and $61 thousand in loan service fees. We attribute these increases primarily to growth in the bank.

Gains on sale on government guaranteed loans decreased by $107 thousand. Proceeds from SBA loan sales totaled $37.3 million during the current period and $31.4 million for the nine months ended September 30, 2017. Loans originated for sale totaled $34.3 million during the nine months ended September 30, 2018 and $27.2 million during the nine months ended September 30, 2017. The decline in gain on sale mostly relates to a decline in the average premium received on sale. As market rates increase, rates on SBA loans which are variable rate and tied to Prime increase which typically results in an increase in prepay speed on these loans which adversely effects the premium received on sale.

The following table describes the components of non-interest income for the nine-month periods ended September 30, 2018 and 2017, dollars in thousands:

	For the Nine Months Ended September 30				
	2018	**2017**	**Dollar Change**	**Percentage Change**	
Service charges on deposit accounts	$1,919	$1,841	$ 78	4.2	%
Gain on sale of loans, net	1,763				