

TRICO BANCSHARES /
Form 10-Q
August 09, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2011

for the quarterly period ended: June, 30 2011

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: 000-10661

TriCo Bancshares

(Exact Name of Registrant as Specified in Its Charter)

CALIFORNIA
(State or Other Jurisdiction
of Incorporation or Organization)

94-2792841
(I.R.S. Employer
Identification Number)

63 Constitution Drive
Chico, California 95973
(Address of Principal Executive Offices)(Zip Code)
(530) 898-0300

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding for each of the issuer's classes of common stock, as of the latest practical date:

Common stock, no par value: 15,978,958 shares outstanding as of August 5, 2011

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FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements about TriCo Bancshares (the Company) that are subject to the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on the current knowledge and belief of the Company's management (Management) and include information concerning the Company's possible or assumed future financial condition and results of operations. When you see any of the words believes, expects, anticipates, estimates, or similar expressions, it may mean the Company is making forward-looking statements. A number of factors, some of which are beyond the Company's ability to predict or control, could cause future results to differ materially from those contemplated. The reader is directed to the Company's annual report on Form 10-K for the year ended December 31, 2010, and Part II, Item 1A of this report for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those suggested by any forward-looking statement made in this report. Such Form 10-K and this report should be read to put any forward-looking statements in context and to gain a more complete understanding of the risks and uncertainties involved in the Company's business. Any forward-looking statement may turn out to be wrong and cannot be guaranteed. The Company does not intend to update any forward-looking statement after the date of this report.

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TRICO BANCSHARES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data; unaudited)

	At June 30, 2011	At December 31, 2010
Assets:		
Cash and due from banks	\$ 52,874	\$ 57,254
Cash at Federal Reserve and other banks	338,180	313,812
Cash and cash equivalents	391,054	371,066
Securities available-for-sale	264,992	277,271
Restricted equity securities	9,199	9,133
Loans held for sale	4,379	4,988
Loans	1,396,062	1,419,571
Allowance for loan losses	(43,962)	(42,571)
Total loans, net	1,352,100	1,377,000
Foreclosed assets, net	9,337	9,913
Premises and equipment, net	20,142	19,120
Cash value of life insurance	51,441	50,541
Accrued interest receivable	6,549	7,131
Goodwill	15,519	15,519
Other intangible assets, net	475	580
Mortgage servicing rights	4,818	4,605
Indemnification asset	4,545	5,640
Other assets	41,634	37,282
Total assets	\$ 2,176,184	\$ 2,189,789
Liabilities and Shareholders Equity:		
Liabilities:		
Deposits:		
Noninterest-bearing demand	\$ 419,391	\$ 424,070
Interest-bearing	1,417,340	1,428,103
Total deposits	1,836,731	1,852,173
Accrued interest payable	1,865	2,151
Reserve for unfunded commitments	2,640	2,640
Other liabilities	29,561	29,170
Other borrowings	59,234	62,020
Junior subordinated debt	41,238	41,238
Total liabilities	1,971,269	1,989,392

Commitments and contingencies (Note 18)

Shareholders' equity:

Common stock, no par value: 50,000,000 shares authorized; issued and outstanding:

15,978,958 at June 30, 2011	83,863	
15,860,138 at December 31, 2010		81,554
Retained earnings	118,408	117,533
Accumulated other comprehensive income, net of tax	2,644	1,310
Total shareholders' equity	204,915	200,397
Total liabilities and shareholders' equity	\$ 2,176,184	\$ 2,189,789

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

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TRICO BANCSHARES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data; unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Interest and dividend income:				
Loans, including fees	\$ 21,735	\$ 22,701	\$ 43,457	\$ 45,514
Debt securities:				
Taxable	2,347	2,727	4,721	5,482
Tax exempt	136	188	276	396
Dividends	7	6	14	12
Interest bearing cash at Federal Reserve and other banks	242	154	433	308
Total interest and dividend income	24,467	25,776	48,901	51,712
Interest expense:				
Deposits	1,802	2,727	3,629	5,785
Other borrowings	600	602	1,193	1,196
Junior subordinated debt	312	313	622	619
Total interest expense	2,714	3,642	5,444	7,600
Net interest income	21,753	22,134	43,457	44,112
Provision for loan losses	5,561	10,000	12,562	18,500
Net interest income after provision for loan losses	16,192	12,134	30,895	25,612
Noninterest income:				
Service charges and fees	6,121	6,082	11,903	11,817
Gain on sale of loans	495	577	1,220	1,162
Commissions on sale of non-deposit investment products	648	362	1,008	629
Increase in cash value of life insurance	450	426	900	852
Other	537	657	2,570	1,191
Total noninterest income	8,251	8,104	17,601	15,651
Noninterest expense:				
Salaries and related benefits	10,715	9,985	21,508	20,135
Other	9,380	8,423	18,258	17,076
Total noninterest expense	20,095	18,408	39,766	37,211
Income before income taxes	4,348	1,830	8,730	4,052
Provision for income taxes	1,577	510	3,159	1,174

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Net income	\$ 2,771	\$ 1,320	5,571	\$ 2,878
Earnings per share:				
Basic	\$ 0.17	\$ 0.08	\$ 0.35	\$ 0.18
Diluted	\$ 0.17	\$ 0.08	\$ 0.35	\$ 0.18

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

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TRICO BANCSHARES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(In thousands, except share data; unaudited)

	Shares of Common Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2009	15,787,753	\$ 79,508	\$ 118,863	\$ 2,278	\$ 200,649
Comprehensive income:					
Net income			2,878		2,878
Change in net unrealized loss on securities available for sale, net				1,854	1,854
Total comprehensive income					4,732
Stock option vesting		275			275
Stock options exercised	146,403	1,229			1,229
Tax benefit of stock options exercised		390			390
Repurchase of common stock	(74,018)	(373)	(991)		(1,364)
Dividends paid (\$0.22 per share)			(3,489)		(3,489)
Balance at June 30, 2010	15,860,138	\$ 81,029	\$ 117,261	\$ 4,132	\$ 202,422
Balance at December 31, 2010	15,860,138	\$ 81,554	\$ 117,533	\$ 1,310	\$ 200,397
Comprehensive income:					
Net income			5,571		5,571
Change in net unrealized gain on securities available for sale, net				1,334	1,334
Total comprehensive income					6,905
Stock option vesting		500			500
Stock options exercised	296,250	2,428			2,428
Tax benefit of stock options exercised		296			296
Repurchase of common stock	(177,430)	(915)	(1,830)		(2,745)
Dividends paid (\$0.18 per share)			(2,866)		(2,866)
Balance at June 30, 2011	15,978,958	\$ 83,863	\$ 118,408	\$ 2,644	\$ 204,915

See accompanying notes to unaudited condensed consolidated financial statements.

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TRICO BANCSHARES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands; unaudited)

	For the six months ended June	
	30,	
	2011	2010
Operating activities:		
Net income	\$ 5,571	\$ 2,878
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment, and amortization	1,612	1,810
Amortization of intangible assets	105	137
Provision for loan losses	12,562	18,500
Amortization of investment securities premium, net	685	432
Originations of loans for resale	(55,579)	(36,420)
Proceeds from sale of loans originated for resale	56,973	37,508
Gain on sale of loans	(1,220)	(1,162)
Change in market value of mortgage servicing rights	222	618
Provision for losses on foreclosed assets	1,087	55
Gain on sale of foreclosed assets	(385)	(350)
Loss on disposal of fixed assets	15	40
Increase in cash value of life insurance	(900)	(852)
Stock option vesting expense	500	275
Stock option excess tax benefits	(296)	(390)
Bargain purchase gain		(232)
Change in reserve for unfunded commitments		(800)
Change in:		
Interest receivable	582	291
Interest payable	(286)	(1,127)
Other assets and liabilities, net	(3,900)	1,266
Net cash from operating activities	17,348	22,477
Investing activities:		
Proceeds from maturities of securities available-for-sale	39,352	42,816
Purchases of securities available-for-sale	(25,456)	(101,255)
Redemption (purchase) of restricted equity securities, net	(66)	447
Loan principal (increases) decreases, net	8,084	40,097
Proceeds from sale of foreclosed assets	4,145	2,497
Improvements of foreclosed assets	(17)	
Proceeds from sale of premises and equipment	1	2
Purchases of premises and equipment	(2,288)	(1,691)
Cash received from acquisitions		18,764
Net cash from investing activities	23,755	1,677
Financing activities:		

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Net decrease in deposits	(15,442)	(33,564)
Net change in short-term other borrowings	(2,786)	(11,301)
Stock option excess tax benefits	296	390
Repurchase of common stock	(753)	(338)
Dividends paid	(2,866)	(3,489)
Exercise of stock options	436	203
Net cash from financing activities	(21,115)	(48,099)
Net change in cash and cash equivalents	19,988	(23,945)
Cash and cash equivalents at beginning of period	371,066	346,589
Cash and cash equivalents at end of period	\$ 391,054	\$ 322,644
Supplemental disclosure of noncash activities:		
Loans transferred to other real estate owned	\$ 4,254	\$ 3,788
Unrealized net gain on securities available for sale	\$ 2,302	\$ 3,200
Market value of shares tendered by employees in-lieu of cash to pay for exercise options and/or related taxes	\$ 1,992	\$ 1,026
Supplemental disclosure of cash flow activity:		
Cash paid for interest expense	\$ 5,730	\$ 8,727
Cash paid for income taxes	\$ 2,620	\$ 2,625

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

Table of Contents**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Note 1 General Summary of Significant Accounting Policies**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations reflect interim adjustments, all of which are of a normal recurring nature and which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The interim results are not necessarily indicative of the results expected for the full year. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes as well as other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, and its wholly-owned subsidiary, Tri Counties Bank (the Bank). All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to the adequacy of the allowance for loan losses, investments, intangible assets, income taxes and contingencies. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The allowance for loan losses, goodwill and other intangible assets, income taxes, and the valuation of mortgage servicing rights are the only accounting estimates that materially affect the Company's consolidated financial statements.

Significant Group Concentration of Credit Risk

The Company grants agribusiness, commercial, consumer, and residential loans to customers located throughout the northern San Joaquin Valley, the Sacramento Valley and northern mountain regions of California. The Company has a diversified loan portfolio within the business segments located in this geographical area. The Company currently classifies all its operation into one business segment that it denotes as community banking.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold.

Investment Securities

The Company classifies its debt and marketable equity securities into one of three categories: trading, available-for-sale or held-to-maturity. Trading securities are bought and held principally for the purpose of selling in the near term. Held-to-maturity securities are those securities which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity are classified as available-for-sale. During the six months ended June 30, 2011 and the year ended December 31, 2010, the Company did not have any securities classified as either held-to-maturity or trading.

Available-for-sale securities are recorded at fair value. Unrealized gains and losses, net of the related tax effect, on available-for-sale securities are reported as a separate component of other accumulated comprehensive income (loss) in shareholders' equity until realized.

Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned. Realized gains and losses are derived from the amortized cost of the security sold.

The Company assesses an other-than-temporary impairment (OTTI) based on whether it intends to sell a security or if it is likely that the Company would be required to sell the security before recovery of the amortized cost basis of the

investment, which may be maturity. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (OCI). Impairment losses related to all other factors are presented as separate categories within OCI. For investment securities held to maturity, this amount is accreted over the remaining life of the debt security prospectively based on the amount and timing of future estimated cash flows. The accretion of the amount recorded in OCI increases the

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carrying value of the investment and does not affect earnings. If there is an indication of additional credit losses the security is re-evaluated according to the procedures described above. No OTTI losses were recognized in the six months ended June 30, 2011 or the year ended December 31, 2010.

Restricted Equity Securities

Restricted equity securities represent the Company's investment in the stock of the Federal Home Loan Bank of San Francisco (FHLB) and are carried at par value, which reasonably approximates its fair value. While technically these are considered equity securities, there is no market for the FHLB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates FHLB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

As a member of the FHLB system, the Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. The Company may request redemption at par value of any stock in excess of the minimum required investment. Stock redemptions are at the discretion of the FHLB.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors of current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to noninterest income.

Mortgage loans held for sale are generally sold with the mortgage servicing rights retained by the Company. The carrying value of mortgage loans sold is reduced by the cost allocated to the associated mortgage servicing rights. Gains or losses on the sale of loans that are held for sale are recognized at the time of the sale and determined by the difference between net sale proceeds and the net book value of the loans less the estimated fair value of any retained mortgage servicing rights.

Loans and Allowance for Loan Losses

Loans originated by the Company, i.e., not purchased or acquired in a business combination, are reported at the principal amount outstanding, net of deferred loan fees and costs. Loan origination and commitment fees and certain direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loan's yield over the actual life of the loan. Originated loans on which the accrual of interest has been discontinued are designated as nonaccrual loans.

Originated loans are placed in nonaccrual status when reasonable doubt exists as to the full, timely collection of interest or principal, or a loan becomes contractually past due by 90 days or more with respect to interest or principal and is not well secured and in the process of collection. When an originated loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of Management, the loan is estimated to be fully collectible as to both principal and interest.

An allowance for loan losses for originated loans is established through a provision for loan losses charged to expense. Originated loans and deposit related overdrafts are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely or, with respect to consumer installment loans, according to an established delinquency schedule. The allowance is an amount that Management believes will be adequate to absorb probable losses inherent in existing loans and leases, based on evaluations of the collectability, impairment and prior loss experience of loans and leases. The evaluations take into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The Company defines an originated loan as impaired when it

is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired originated loans are measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

In situations related to originated loans where, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession for other than an insignificant period of time to the borrower that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Company strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where the Company grants the borrower new terms that provide for a reduction of either interest or principal, the Company measures any impairment on the restructuring as noted above for impaired loans. TDR loans are classified as impaired until they are fully paid off or charged off. Loans that are in nonaccrual status at the time they become TDR loans, remain in

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nonaccrual status until the borrower demonstrates a sustained period of performance which the Company generally believes to be six consecutive months of payments, or equivalent. Otherwise, TDR loans are subject to the same nonaccrual and charge-off policies as noted above with respect to their restructured principal balance.

Credit risk is inherent in the business of lending. As a result, the Company maintains an allowance for loan losses to absorb losses inherent in the Company's originated loan portfolio. This is maintained through periodic charges to earnings. These charges are included in the Consolidated Income Statements as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. However, for a variety of reasons, not all losses are immediately known to the Company and, of those that are known, the full extent of the loss may not be quantifiable at that point in time. The balance of the Company's allowance for originated loan losses is meant to be an estimate of these unknown but probable losses inherent in the portfolio.

The Company formally assesses the adequacy of the allowance for originated loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding originated loan portfolio, and to a lesser extent the Company's originated loan commitments. These assessments include the periodic re-grading of credits based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment, growth of the portfolio as a whole or by segment, and other factors as warranted. Loans are initially graded when originated. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Company's method for assessing the appropriateness of the allowance for originated loan losses includes specific allowances for impaired originated loans and leases, formula allowance factors for pools of credits, and allowances for changing environmental factors (e.g., interest rates, growth, economic conditions, etc.). Allowance factors for loan pools are based on historical loss experience by product type. Allowances for impaired loans are based on analysis of individual credits. Allowances for changing environmental factors are Management's best estimate of the probable impact these changes have had on the originated loan portfolio as a whole. The allowance for originated loans is included in the allowance for loan losses.

Acquired loans are valued as of acquisition date in accordance with Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) Topic 805, *Business Combinations*. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are referred to as purchased credit impaired (PCI) loans. PCI loans are accounted for under FASB ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. In addition, because of the significant credit discounts associated with the loans acquired in the Granite acquisition, the Company elected to account for all loans acquired in the Granite acquisition under FASB ASC Topic 310-30, and classify them all as PCI loans. Under FASB ASC Topic 805 and FASB ASC Topic 310-30, PCI loans are recorded at fair value at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded as of the acquisition date. Fair value is defined as the present value of the future estimated principal and interest payments of the loan, with the discount rate used in the present value calculation representing the estimated effective yield of the loan. Default rates, loss severity, and prepayment speed assumptions are periodically reassessed and our estimate of future payments is adjusted accordingly. The difference between contractual future payments and estimated future payments is referred to as the nonaccretable difference. The difference between estimated future payments and the present value of the estimated future payments is referred to as the accretable yield. The accretable yield represents the amount that is expected to be recorded as interest income over the remaining life of the loan. If after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be more than the originally estimated, an increase in the discount rate (effective yield) would be made such that the newly increased accretable yield would be recognized, on a level yield basis, over the remaining estimated life of the loan. If after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be less than the previously estimated, the discount rate would first be reduced until the present value of the reduced cash flow estimate equals the previous present value however, the discount rate may not be

lowered below its original level at acquisition. If the discount rate has been lowered to its original level and the present value has not been sufficiently lowered, an allowance for loan loss would be established through a provision for loan losses charged to expense to decrease the present value to the required level. If the estimated cash flows improve after an allowance has been established for a loan, the allowance may be partially or fully reversed depending on the improvement in the estimated cash flows. Only after the allowance has been fully reversed may the discount rate be increased. PCI loans are put on nonaccrual status when cash flows cannot be reasonably estimated. PCI loans are charged off when evidence suggests cash flows are not recoverable. Foreclosed assets from PCI loans are recorded in foreclosed assets at fair value with the fair value at time of foreclosure representing cash flow from the loan. ASC 310-30 allows PCI loans with similar risk characteristics and acquisition time frame to be pooled and have their cash flows aggregated as if they were one loan.

Loans are also categorized as covered or noncovered. Covered loans refer to loans covered by a Federal Deposit Insurance Corporation (FDIC) loss sharing agreement. Noncovered loans refer to loans not covered by a FDIC loss sharing agreement.

Table of Contents**Foreclosed Assets**

Foreclosed assets include assets acquired through, or in lieu of, loan foreclosure. Foreclosed assets are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, management periodically performs valuations and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense. Foreclosed assets that are not subject to a FDIC loss-share agreement are referred to as noncovered foreclosed assets.

Foreclosed assets acquired through FDIC-assisted acquisitions that are subject to a FDIC loss-share agreement, and all assets acquired via foreclosure of covered loans are referred to as covered foreclosed assets. Covered foreclosed assets are reported exclusive of expected reimbursement cash flows from the FDIC. Foreclosed covered loan collateral is transferred into covered foreclosed assets at the loan's carrying value, inclusive of the acquisition date fair value discount.

Covered foreclosed assets are initially recorded at estimated fair value on the acquisition date based on similar market comparable valuations less estimated selling costs. Any subsequent valuation adjustments due to declines in fair value will be charged to noninterest expense, and will be mostly offset by noninterest income representing the corresponding increase to the FDIC indemnification asset for the offsetting loss reimbursement amount. Any recoveries of previous valuation adjustments will be credited to noninterest expense with a corresponding charge to noninterest income for the portion of the recovery that is due to the FDIC.

Premises and Equipment

Land is carried at cost. Buildings and equipment, including those acquired under capital lease, are stated at cost less accumulated depreciation and amortization. Depreciation and amortization expenses are computed using the straight-line method over the estimated useful lives of the related assets or lease terms. Asset lives range from 3-10 years for furniture and equipment and 15-40 years for land improvements and buildings.

Goodwill and Other Intangible Assets

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and other intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment. The Company has identifiable intangible assets consisting of core deposit intangibles (CDI) and minimum pension liability. CDI are amortized using an accelerated method over a period of ten years. Intangible assets related to minimum pension liability are adjusted annually based upon actuarial estimates.

Impairment of Long-Lived Assets and Goodwill

Long-lived assets, such as premises and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

As of December 31 of each year, goodwill is tested for impairment, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of a reporting unit and compares it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill.

Currently, and historically, the Company is comprised of only one reporting unit that operates within the business segment it has identified as community banking .

Mortgage Servicing Rights

Mortgage servicing rights (MSR) represent the Company's right to a future stream of cash flows based upon the contractual servicing fee associated with servicing mortgage loans. Our MSR arise from residential mortgage loans that we originate and sell, but retain the right to service the loans. For sales of residential mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on the fair values of the loan and the servicing right. The net gain from the retention of the servicing right is included in gain on sale of loans in noninterest income when the loan is sold. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. MSR are included in other assets. Servicing fees are recorded in noninterest income when earned.

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The determination of fair value of our MSR requires management judgment because they are not actively traded. The determination of fair value for MSR requires valuation processes which combine the use of discounted cash flow models and extensive analysis of current market data to arrive at an estimate of fair value. The cash flow and prepayment assumptions used in our discounted cash flow model are based on empirical data drawn from the historical performance of our MSR, which we believe are consistent with assumptions used by market participants valuing similar MSR, and from data obtained on the performance of similar MSR. The key assumptions used in the valuation of MSR include mortgage prepayment speeds and the discount rate. These variables can, and generally will, change from quarter to quarter as market conditions and projected interest rates change. The key risks inherent with MSR are prepayment speed and changes in interest rates. The Company uses an independent third party to determine fair value of MSR.

Indemnification Asset

The Company has elected to account for amounts receivable under loss-share agreements with the FDIC as indemnification assets in accordance with FASB ASC Topic 805, *Business Combinations*. FDIC indemnification assets are initially recorded at fair value, based on the discounted value of expected future cash flows under the loss-share agreements. The difference between the fair value and the undiscounted cash flows the Company expects to collect from the FDIC will be accreted into noninterest income over the life of the FDIC indemnification asset. FDIC indemnification assets are reviewed quarterly and adjusted for any changes in expected cash flows based on recent performance and expectations for future performance of the covered portfolios. These adjustments are measured on the same basis as the related covered loans and covered other real estate owned. Any increases in cash flow of the covered assets over those expected will reduce the FDIC indemnification asset and any decreases in cash flow of the covered assets under those expected will increase the FDIC indemnification asset. Increases and decreases to the FDIC indemnification asset are recorded as adjustments to noninterest income.

Reserve for Unfunded Commitments

The reserve for unfunded commitments is established through a provision for losses unfunded commitments charged to noninterest expense. The reserve for unfunded commitments is an amount that Management believes will be adequate to absorb probable losses inherent in existing commitments, including unused portions of revolving lines of credits and other loans, standby letters of credits, and unused deposit account overdraft privilege. The reserve for unfunded commitments is based on evaluations of the collectability, and prior loss experience of unfunded commitments. The evaluations take into consideration such factors as changes in the nature and size of the loan portfolio, overall loan portfolio quality, loan concentrations, specific problem loans and related unfunded commitments, and current economy.