

SIERRA BANCORP  
Form 10-K/A  
July 23, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-K/A**

**Amendment No. 1**

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

**For the fiscal year ended December 31, 2013**

**Commission file number: 000-33063**

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**SIERRA BANCORP**

(Exact name of registrant as specified in its charter)

**California**                      **33-0937517**  
(State of incorporation) (I.R.S. Employer Identification No.)

**86 North Main Street, Porterville, California 93257**  
(Address of principal executive offices)                      (Zip Code)

**(559) 782-4900**

Registrant's telephone number, including area code

**Securities registered pursuant to Section 12(b) of the Act:**

| <u>Title of each class</u> | <u>Name of each exchange on which registered</u>          |
|----------------------------|---|
| Common Stock, No Par Value | The NASDAQ Stock Market LLC (NASDAQ Global Select Market) |

**Securities registered pursuant to Section 12(g) of the Act: None**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes       No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes       No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

Yes  No

As of June 28, 2013, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$160 million, based on the closing price reported to the registrant on that date of \$14.80 per share. Shares of Common Stock held by each officer and director and each person or control group owning more than ten percent of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of common stock of the registrant outstanding as of February 28, 2014 was 14,240,399.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

## EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 10-K for Sierra Bancorp (the “Company”) for the fiscal year ended December 31, 2013 initially filed on March 13, 2014 (the “Original Filing”), is being filed to reflect certain corrections by our independent registered public accounting firm to their reports included in the Original Filing. Specifically, this Amendment includes (i) the revised accountants’ report concerning the Company’s consolidated financial statements, to specifically include the Company’s consolidated statements of comprehensive income with the financial statements listed in the first paragraph of that report; and (ii) the revised accountants’ report concerning the Company’s internal control over financial reporting, to reference the fact that the Company utilized the original (1992) version of the Internal Control – Integrated Framework issued by COSO.

This Amendment is specifically intended to make only the two changes described above to the Company’s 10-K for the year ended December 31, 2013. In addition, this Amendment includes new Section 302 and Section 906 certifications as required by SEC Rule 12b-15, and modifies the list of exhibits as necessary due to the filing of this Amendment. All other information presented in the Original Filing is unaffected by this Amendment, and has thus not been reiterated herein. All information in this Amendment is as of the date of the Original Filing and does not reflect any subsequent information or events occurring after the date of the Original Filing. As this Amendment does not include any changes to the financial statements or notes thereto, only a correction to the scope of the accountants’ report, the interactive data files pursuant to Rule 405 of Regulation S-T have not been updated in this Amendment.

**Item 8. Financial Statements and Supplementary Data**

The following financial statements and independent auditors' reports listed below are included herein:

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**Report of Independent Registered Public Accounting Firm**

Board of Directors

Sierra Bancorp and Subsidiary

Porterville, California

We have audited the accompanying consolidated balance sheets of Sierra Bancorp and Subsidiary (the “Company”) as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sierra Bancorp and Subsidiary as of December 31, 2013 and 2012, and the results of its operations, changes in its shareholders' equity, and its cash flows for each of the years in the three year period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 13, 2014 expressed an unqualified opinion thereon.

/s/ Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California  
March 13, 2014



**SIERRA BANCORP AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS****December 31, 2013 and 2012**

(dollars in thousands)

|   | 2013               | 2012               |
|---|--------------------|--------------------|
| <b>ASSETS</b>                                     |                    |                    |
| Cash and due from banks                           | \$51,342           | \$42,079           |
| Interest-bearing deposits in banks                | 26,664             | 19,739             |
| Cash and cash equivalents                         | 78,006             | 61,818             |
| Investment securities available-for-sale          | 425,044            | 380,188            |
| Loans held-for-sale                               | 105                | 210                |
| Loans and leases:                                 |                    |                    |
| Gross loans and leases                            | 803,242            | 879,795            |
| Allowance for loan and lease losses               | (11,677)           | (13,873)           |
| Deferred loan and lease fees, net                 | 1,522              | 1,156              |
| Net Loans and Leases                              | 793,087            | 867,078            |
| Premises and equipment, net                       | 20,393             | 21,830             |
| Operating leases, net                             | -                  | 12                 |
| Foreclosed assets                                 | 8,185              | 19,754             |
| Goodwill  | 5,544              | 5,544              |
| Other assets                                      | 79,885             | 81,469             |
| <b>Total Assets</b>                               | <b>\$1,410,249</b> | <b>\$1,437,903</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                    |                    |
| <b>Deposits:</b>                                  |                    |                    |
| Non-interest bearing                              | \$365,997          | \$352,597          |
| Interest bearing                                  | 808,182            | 821,437            |
| <b>Total Deposits</b>                             | <b>1,174,179</b>   | <b>1,174,034</b>   |
| Federal funds purchased and repurchase agreements | 5,974              | 1,419              |
| Short-term borrowings                             | -                  | 36,650             |
| Long-term borrowings                              | -                  | 5,000              |
| Subordinated debentures                           | 30,928             | 30,928             |
| Other liabilities                                 | 17,494             | 15,980             |
| <b>Total liabilities</b>                          | <b>1,228,575</b>   | <b>1,264,011</b>   |



Commitments and contingencies (Note 11)

Shareholders' equity

|   |             |             |
|---|-------------|-------------|
| Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued   |             |             |
| Common stock, no par value; 24,000,000 shares authorized; 14,217,199 and 14,106,959 shares issued and outstanding in 2013 and 2012 respectively | 65,780      | 64,384      |
| Additional paid in capital  | 2,648       | 2,660       |
| Retained earnings   | 112,817     | 103,128     |
| Accumulated other comprehensive income, net of taxes of \$300 in 2013 and \$2,602 in 2012   | 429         | 3,720       |
| Total shareholders' equity  | 181,674     | 173,892     |
| Total liabilities and shareholders' equity  | \$1,410,249 | \$1,437,903 |

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

**SIERRA BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF INCOME****Years Ended December 31, 2013, 2012 and 2011**

(dollars in thousands, except per share data)

|  | 2013     | 2012     | 2011     |
|--|----------|----------|----------|
| Interest income:   |          |          |          |
| Interest and fees on loans and leases                                | \$44,030 | \$45,765 | \$46,959 |
| Interest on investment securities:                                   |          |          |          |
| Taxable  | 4,916    | 6,364    | 8,753    |
| Exempt from federal tax  | 2,737    | 2,703    | 2,834    |
| Interest on Federal funds sold and interest-bearing deposits         | 102      | 70       | 68       |
| Total interest income  | 51,785   | 54,902   | 58,614   |
| Interest expense:  |          |          |          |
| Interest on deposits   | 2,455    | 3,208    | 4,305    |
| Interest on short-term borrowings                                    | 19       | 58       | 55       |
| Interest on long-term borrowings                                     | 33       | 281      | 569      |
| Interest on subordinated debentures                                  | 714      | 774      | 728      |
| Total interest expense   | 3,221    | 4,321    | 5,657    |
| Net Interest Income  | 48,564   | 50,581   | 52,957   |
| Provision for loan and lease losses                                  | 4,350    | 14,210   | 12,000   |
| Net Interest Income after Provision for Loan and lease losses        | 44,214   | 36,371   | 40,957   |
| Non-interest revenue:  |          |          |          |
| Service charges on deposit accounts                                  | 9,022    | 9,676    | 9,543    |
| Gain on sale of loans  | 129      | 183      | 139      |
| Credit card fees   | 462      | 390      | 411      |
| Checkcard fees   | 3,749    | 2,787    | 2,519    |
| Gains on sales and calls of investment securities available-for-sale | 6        | 1,762    | 1,660    |
| Other-than-temporary impairment losses on equity securities          | -        | -        | (1,370)  |
| Increase in cash surrender value of life insurance                   | 1,787    | 1,420    | 934      |
| Other income   | 1,908    | 1,908    | 1,156    |
| Total non-interest revenue   | 17,063   | 18,126   | 14,992   |
| Other operating expense:   |          |          |          |

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|                                 |          |         |         |
|---------------------------------|----------|---------|---------|
| Salaries and employee benefits  | 21,920   | 20,734  | 20,669  |
| Occupancy and equipment expense | 6,274    | 6,381   | 6,758   |
| Other                           | 16,621   | 19,541  | 20,178  |
| Total non-interest expense      | 44,815   | 46,656  | 47,605  |
| Income before income taxes      | 16,462   | 7,841   | 8,344   |
| Provision for income taxes      | 3,093    | (344)   | 564     |
| Net Income                      | \$13,369 | \$8,185 | \$7,780 |
| Earnings per share:             |          |         |         |
| Basic                           | \$0.94   | \$0.58  | \$0.55  |
| Diluted                         | \$0.94   | \$0.58  | \$0.55  |

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

**SIERRA BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****Years Ended December 31, 2013, 2012 and 2011**

(dollars in thousands)

|  | 2013     | 2012    | 2011     |
|--|----------|---------|----------|
| Net (loss) income  | \$13,369 | \$8,185 | \$7,780  |
| Other comprehensive income, before tax:  |          |         |          |
| Unrealized gains on securities:  |          |         |          |
| Unrealized holding (losses) gains arising during period                                      | (5,588)  | 1,560   | 5,266    |
| Less: reclassification adjustment for gains included in net income                           | (6)      | (1,762) | (1,660)  |
| Plus: reclassification adjustment or other-than-temporary impairment losses (credit portion) | -        | -       | 1,370    |
| Other comprehensive (loss) income, before tax  | (5,594)  | (202)   | 4,976    |
| Income tax benefit (expense) related to items of other comprehensive income, net of tax      | 2,303    | 74      | (2,026)  |
| Other comprehensive (loss) income  | (3,291)  | (128)   | 2,950    |
| Comprehensive income   | \$10,078 | \$8,057 | \$10,730 |

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

**SIERRA BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****For the Three Years Ended December 31, 2013**

(dollars in thousands, except per share data)

|   | Common Stock<br>Shares | Common Stock<br>Amount | Additional<br>Paid In<br>Capital | Retained<br>Earnings | Accumulated Other<br>Comprehensive<br>Income | Shareholders'<br>Equity |
|---|------------------------|------------------------|----------------------------------|----------------------|--|-------------------------|
| Balance, January 1, 2011  | 13,976,741             | \$63,477               | \$ 1,652                         | \$93,570             | \$ 898                                       | \$ 159,597              |
| Net Income  |                        |                        |                                  | 7,780                |  | 7,780                   |
| Net change in unrealized gain on<br>investment securities available- for-<br>sale, net of tax |                        |                        |                                  |                      | 2,950  | 2,950                   |
| Reversal of Cumulative effect of<br>change in accounting principle<br>(EITF 06-4)             |                        |                        |                                  | 191                  |  | 191                     |
| Issuance of Common stock  |                        | (23)                   |                                  |                      |  | (23)                    |
| Exercise of stock options and related<br>tax benefit  | 124,868                | 867                    | 109                              |                      |  | 976                     |
| Stock compensation costs  |                        |                        | 460                              |                      |  | 460                     |
| Cash dividends - \$.24 per share  |                        |                        |                                  | (3,367)              |  | (3,367)                 |
| Balance, December 31, 2011  | 14,101,609             | 64,321                 | 2,221                            | 98,174               | 3,848  | 168,564                 |
| Net Income  |                        |                        |                                  | 8,185                |  | 8,185                   |
| Net change in unrealized gain on<br>investment securities available- for-<br>sale, net of tax |                        |                        |                                  |                      | (128)  | (128)                   |
| Reversal of Cumulative effect of<br>change in accounting principle<br>(EITF 06-4)             |                        |                        |                                  | 154                  |  | 154                     |
| Exercise of stock options and related<br>tax benefit  | 5,350                  | 63                     | (48)                             |                      |  | 15                      |
| Stock compensation costs  |                        |                        | 487                              |                      |  | 487                     |
| Cash dividends - \$.24 per share  |                        |                        |                                  | (3,385)              |  | (3,385)                 |
| Balance, December 31, 2012  | 14,106,959             | 64,384                 | 2,660                            | 103,128              | 3,720  | 173,892                 |
| Net Income  |                        |                        |                                  | 13,369               |  | 13,369                  |

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|  |            |          |          |           |         |         |            |
|--|------------|----------|----------|-----------|---------|---------|------------|
| Net change in unrealized gain on investment securities available- for-sale, net of tax |            |          |          |           |         | (3,291) | (3,291)    |
| Exercise of stock options and related tax benefit                                      | 110,240    | 1,396    | (280)    |           |         |         | 1,116      |
| Stock compensation costs   |            |          | 268      |           |         |         | 268        |
| Cash dividends - \$.26 per share   |            |          |          |           | (3,680) |         | (3,680)    |
| Balance, December 31, 2013   | 14,217,199 | \$65,780 | \$ 2,648 | \$112,817 | \$ 429  |         | \$ 181,674 |

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

**SIERRA BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS****Years Ended December 31, 2013, 2012, and 2011**

(dollars in thousands)

|   | 2013      | 2012      | 2011      |
|---|-----------|-----------|-----------|
| Cash flows from operating activities:   |           |           |           |
| Net income  | \$13,369  | \$8,185   | \$7,780   |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |           |           |
| Gain on investment of securities  | (6)       | \$(1,762) | \$(1,660) |
| Other-than-temporary impairment loss  | -         | -         | 1,370     |
| Gain on sales of loans  | (129)     | (183)     | (139)     |
| (Gain) loss on disposal of fixed assets   | (15)      | 30        | 25        |
| Loss on sale of foreclosed assets   | 223       | 864       | 451       |
| Writedown of foreclosed assets  | 730       | 3,173     | 4,184     |
| Share-based compensation expense  | 268       | 487       | 460       |
| Provision for loan losses   | 4,350     | 14,210    | 12,000    |
| Depreciation and amortization   | 2,131     | 2,437     | 2,695     |
| Net amortization on securities premiums and discounts                             | 8,177     | 8,500     | 5,874     |
| Decrease (increase) in unearned net loan fees                                     | 366       | (535)     | (509)     |
| Increase in cash surrender value of life insurance policies                       | (1,417)   | (350)     | (934)     |
| Proceeds from sales of loans  | 5,459     | 8,191     | 7,210     |
| Originations of Loans Held For Sale   | (5,225)   | (6,864)   | (7,511)   |
| Decrease in interest receivable and other assets                                  | 2,225     | 610       | 2,354     |
| Increase in other liabilities   | 1,514     | 1,646     | 666       |
| Net decrease in FHLB stock, at cost   | 438       | 670       | 1,321     |
| Deferred income tax provision (benefit)   | 2,360     | (564)     | (881)     |
| Excess tax benefit from equity based compensation                                 | (280)     | (48)      | (109)     |
| Net cash provided by operating activities   | 34,538    | 38,697    | 34,647    |
| Cash flows from investing activities:   |           |           |           |
| Maturities of securities available for sale                                       | 1,724     | 1,120     | 7,107     |
| Proceeds from sales/calls of securities available for sale                        | 4,135     | 63,776    | 46,872    |
| Purchases of securities available for sale  | (160,251) | (150,305) | (205,500) |
| Principal paydowns on securities available for sale                               | 95,772    | 104,752   | 76,171    |
| Decrease (increase) in loans receivable, net                                      | 64,868    | (163,789) | 24,661    |
| Purchases of premises and equipment, net  | (667)     | (3,411)   | (2,734)   |

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|   |           |           |          |
|---|-----------|-----------|----------|
| Proceeds from sales of foreclosed assets            | 15,023    | 15,538    | 7,212    |
| Purchase of bank owned life insurance               | -         | -         | (5,132)  |
| Net cash provided by (used in) investing activities | 20,604    | (132,319) | (51,343) |
| Cash flows from financing activities:               |           |           |          |
| Increase in deposits                                | 145       | 87,766    | 33,994   |
| (Decrease) increase in borrowed funds               | (41,650)  | 9,530     | 2,470    |
| Increase (decrease) in Repurchase Agreements        | 4,555     | (1,618)   | 3,037    |
| Cash dividends paid                                 | (3,680)   | (3,385)   | (3,367)  |
| Issuance of Common Stock                            | -         | -         | (23)     |
| Stock options exercised                             | 1,396     | 63        | 867      |
| Excess tax provision from equity based compensation | 280       | 48        | 109      |
| Net cash (used in) provided by financing activities | (38,954)  | 92,404    | 37,087   |
| Increase (decrease) in cash and due from banks      | 16,188    | (1,218)   | 20,391   |
| Cash and cash equivalents, beginning of year        | 61,818    | 63,036    | 42,645   |
| Cash and cash equivalents, end of year              | \$78,006  | \$61,818  | \$63,036 |
| Supplemental disclosure of cash flow information:   |           |           |          |
| Cash paid during the year for:                      |           |           |          |
| Interest  | \$3,340   | \$4,531   | \$5,492  |
| Income taxes  | \$-       | \$-       | \$1,643  |
| Non-cash investing activities                       |           |           |          |
| Real estate acquired through foreclosure            | \$4,990   | \$23,965  | \$6,520  |
| Change in unrealized net (losses) gains on          |           |           |          |
| Investment securities available-for-sale            | \$(5,594) | \$(202)   | \$4,976  |

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



## **SIERRA BANCORP AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **1. THE BUSINESS OF SIERRA BANCORP**

Sierra Bancorp (the “Company”) is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended, and is headquartered in Porterville, California. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the “Bank”) in August 2001. The Company’s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. The Company’s only other direct subsidiaries are Sierra Statutory Trust II, which was formed in March 2004 solely to facilitate the issuance of capital trust pass-through securities, and Sierra Capital Trust III, which was formed in June 2006 for the same purpose.

The Bank operates twenty-five full service branch offices, an online branch, a real estate industries group, an agricultural credit division, and an SBA lending unit. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable legal limits. The Bank maintains a diversified loan portfolio comprised of agricultural, commercial, consumer, real estate construction and mortgage loans. Loans are made primarily within the market area of the South Central San Joaquin Valley of California, specifically, Tulare, Fresno, Kern, Kings, and Madera counties. These areas have diverse economies with principal industries being agriculture, real estate and light manufacturing.

#### **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of the Company and the consolidated accounts of its wholly-owned subsidiary, Bank of the Sierra. All significant intercompany balances and transactions have been eliminated. Certain reclassifications have been made to prior years' balances to conform to classifications used in 2013. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and prevailing practices within the banking industry.

In accordance with U.S. GAAP, the Company’s investments in Sierra Statutory Trust II and Sierra Capital Trust III are not consolidated and are accounted for under the equity method and included in other assets on the consolidated

balance sheet. The subordinated debentures issued and guaranteed by the Company and held by the trusts are reflected on the Company's consolidated balance sheet.

#### Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Material estimates that are particularly susceptible to significant changes in the near-term relate to the determination of the allowance for loan and lease losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for loan and lease losses and other real estate, management obtains independent appraisals for significant properties, evaluates the overall loan portfolio characteristics and delinquencies and monitors economic conditions.

#### Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and interest bearing deposits in banks.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Investment Securities

Investments are classified into the following categories:

Securities available-for-sale, reported at fair value, with unrealized gains and losses excluded from earnings and reflected, net of tax, as a separate component of shareholders' equity in accumulated other comprehensive income.

Securities held-to-maturity, which the Company has the intent and has the ability to hold to maturity, are carried at cost, adjusted for amortization of premiums and the accretion of discounts.

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value.

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are currently classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. Potential credit impairment is also a consideration. If it is determined that OTTI exists on a security, the entire difference between amortized cost and fair value is recognized as a charge through earnings.

##### Loans and Leases (Financing Receivables)

Our credit quality classifications of Loans and Leases include Pass, Special Mention, Substandard and Impaired. These classifications are defined in Note 4 (Loans and Leases) to our consolidated financial statements.

Loans and leases are reported at the principal amounts outstanding, adjusted for unearned income, deferred loan origination fees and costs, purchase premiums and discounts, write-downs, and the allowance for loan and lease losses. Loan and lease origination fees, net of certain deferred origination costs, and purchase premiums and discounts are recognized as an adjustment to yield of the related loans and leases over the contractual life of the loan using both the effective interest and straight line methods.

Interest income for all performing loans, regardless of classification (Pass, Special Mention, Substandard and Impaired), is recognized on an accrual basis, with interest accrued daily. Costs associated with successful loan originations are netted from loan origination fees, with the net amount (net deferred loan fees) amortized over the contractual life of the loan in interest income. If a loan has scheduled periodic payments, the amortization of the net deferred loan fee is calculated using the effective interest method over the contractual life of the loan. If the loan does not have scheduled payments, such as a line of credit, the net deferred loan fee is recognized as interest income on a straight line basis over the contractual life of the loan. Fees received for loan commitments are recognized as interest income over the term of the commitment. When loans are repaid, any remaining unamortized balances of deferred fees and costs are accounted for through interest income.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Generally, the Company places a loans or lease on nonaccrual status and ceases recognizing interest income when it has become delinquent more than 90 days and/or when Management determines that the repayment of principal and collection of interest is unlikely. The Company may decide that it is appropriate to continue to accrue interest on certain loans more than 90 days delinquent if they are well-secured by collateral and collection is in process. When a loan is placed on nonaccrual status, any accrued but uncollected interest for the loan is reversed out of interest income in the period in which the loan's status changed. For loans with an interest reserve, i.e., where loan proceeds are advanced to the borrower to make interest payments, all interest recognized from the inception of the loan is reversed when the loan is placed on non-accrual. Once a loan is on non-accrual status subsequent payments received from the customer are applied to principal, and no further interest income is recognized until the principal has been paid in full or until circumstances have changed such that payments are again consistently received as contractually required. Generally, loans and leases are not restored to accrual status until the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Impaired loans are classified as either nonaccrual or accrual, depending on individual circumstances regarding the collectability of interest and principal according to the contractual terms.

#### Loans Modified in a Troubled Debt Restructuring

Loans are considered to have been modified in a troubled debt restructuring ("TDR") when due to a borrower's financial difficulties the Company makes certain concessions to the borrower that it would not otherwise consider.

Modifications may include interest rate reductions, principal or interest forgiveness, forbearance, and other actions intended to minimize economic loss and to avoid foreclosure or repossession of collateral. Generally, a non-accrual loan that has been modified in a TDR remains on non-accrual status for a period of six months to demonstrate that the borrower is able to meet the terms of the modified loan. However, performance prior to the modification, or significant events that coincide with the modification, are included in assessing whether the borrower can meet the new terms and may result in the loan being returned to accrual status at the time of loan modification or after a shorter performance period. If the borrower's ability to meet the revised payment schedule is uncertain, the loan remains on non-accrual status. TDRs may be removed from TDR designation in the calendar year following the restructuring, if the loan is in compliance with all modified terms and is yielding a market rate of interest.

A TDR is generally considered to be in default when it appears likely that the customer will not be able to repay all principal and interest pursuant to the terms of the restructured agreement.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Allowance for Loan and Lease Losses

The allowance for loan and lease losses is maintained at a level which, in management's judgment, is adequate to absorb loan and lease losses inherent in the loan and lease portfolio. The allowance for loan and lease losses is increased by a provision for loan and lease losses, which is charged to expense, and reduced by principal charge-offs, net of recoveries. The amount of the allowance is based on management's evaluation of the collectability of the loan and lease portfolio, changes in its risk profile, credit concentrations, historical trends, and economic conditions. This evaluation also considers the balance of impaired loans and leases. A loan or lease is impaired when it is probable that the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan or lease agreement. The impairment on certain individually identified loans or leases is measured based on the present value of expected future cash flows discounted at the original effective interest rate of the loan or lease. As a practical expedient, impairment may be measured based on the loan's or lease's observable market price or the fair value of collateral if the loan or lease is collateral dependent. The amount of impairment, if any, is recorded through the provision for loan and lease losses and is added to the allowance for loan and lease losses, with any changes over time recognized as additional bad debt expense in our provision for loan losses. Impaired loans with homogenous characteristics, such as one-to-four family residential mortgages and consumer installment loans, may be subjected to a collective evaluation for impairment, considering delinquency and repossession statistics, historical loss experience, and other factors.

General reserves cover non-impaired loans and are based on historical net loss rates for each portfolio segment by call report code, adjusted for the effects of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio segment's historical loss experience. Qualitative factors include consideration of the following: changes in lending policies and procedures; changes in international, national, regional, and local economic and business conditions and developments; changes in nature and volume of the portfolio; changes in the experience, ability and depth of lending management and staff; changes in the volume and severity of past due, nonaccrual and other adversely graded loans; changes in quality of the loan review system; changes in the value of the underlying collateral for collateral-dependent loans; concentrations of credit; and the effect of the other external factors such as competition and legal and regulatory requirements.

Most of the Company's business activity is with customers located within the South Central Valley of California, therefore the Company's exposure to credit risk is significantly affected by changes in the economy in that region. The Company considers this concentration of credit risk when assessing and assigning qualitative factors in the allowance for loan losses. Portfolio segments identified by the Company include Direct Financing leases, Agricultural, Commercial and Industrial, Real Estate, Small Business Administration, and Consumer loans. Relevant risk characteristics for these portfolio segments generally include debt service coverage, loan-to-value ratios and financial performance on non-consumer related loans; and credit scores, debt-to-income ratios, collateral type and loan-to-value ratios for consumer related loans.

Though management believes the allowance for loan and lease losses to be adequate, ultimate losses may vary from their estimates. However, estimates are reviewed periodically, and as adjustments become necessary they are reported in earnings during the periods they become known. In addition, the FDIC and the California Department of Business Oversight, as an integral part of their examination processes, review the allowance for loan and lease losses. These agencies may require additions to the allowance for loan and lease losses based on their judgment about information available at the time of their examinations.



## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Reserve for Off-Balance Sheet Commitments

In addition to the exposure to credit loss from outstanding loans, the Company is also exposed to credit loss from certain off-balance sheet commitments such as unused commitments from revolving lines of credit, mortgage warehouse lines of credit, unused commitments on construction loans and commercial and standby letters of credit. Because the available funds have not yet been disbursed on these commitments the estimated losses are not included in the calculation of ALLL. The reserve for off-balance sheet commitments is an estimated loss contingency which is included in other liabilities on the Consolidated Balance Sheets. The adjustments to the reserve for off-balance sheet commitments are reported as a noninterest expense. This reserve is for estimated losses that could occur when the Company is contractually obligated to make a payment under these instruments and must seek repayment from a party that may not be as financially sound in the current period as it was when the commitment was originally made.

##### Sale and Servicing of Loans

The Company periodically originates loans intended to be sold on the secondary market. These loans are recorded as “held for sale” and reported at the lower of cost or fair value in the Consolidated Balance Sheets. The loan’s cost basis includes unearned deferred fees and costs, and premiums and discounts. These loans are generally held between 30 to 90 days from their origination date. Loans held for sale by the Company currently consist entirely of residential real estate loans. Loans classified as held for sale are disclosed in Note 4 of these Consolidated Financial Statements.

Gains and losses on sales of loans are recognized at the time of sale and are calculated based on the difference between the selling price and the allocated book value of loans sold. Book value allocations are determined in accordance with U.S. GAAP. Any inherent risk of loss on loans sold is transferred to the buyer at the date of sale.

The Company has issued various representations and warranties associated with the sale of loans. These representations and warranties may require the Company to repurchase loans with underwriting deficiencies as defined per the applicable sales agreements and certain past due loans within 90 days of the sale. The Company did not experience losses during the years ended December 31, 2013, 2012 or 2011 regarding these representations and warranties.

#### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The useful lives of premises are estimated to be thirty years. The useful lives of furniture, fixtures and equipment are estimated to be three to twenty years. Leasehold improvements are amortized over the life of the asset or the term of the related lease, whichever is shorter. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred.

Impairment of long-lived assets is evaluated by management based upon an event or changes in circumstances surrounding the underlying assets which indicate long-lived assets may be impaired.

**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Foreclosed Assets

Foreclosed assets include real estate and other property acquired in full or partial settlement of loan obligations. When property is acquired, any excess of the recorded investment in the loan balance and accrued interest income over the appraised fair market value of the property, net of estimated selling costs, is charged against the allowance for loan and lease losses. A valuation allowance for losses on foreclosed assets is maintained to provide for temporary declines in value. The allowance is established through a provision for losses on foreclosed assets which is included in other non-interest expense. Subsequent gains or losses on sales or write-downs resulting from permanent impairments are recorded in other non-interest income or expense as incurred.

Goodwill

The Company acquired Sierra National Bank in 2000, and the acquisition was accounted for using the purchase method of accounting. The goodwill resulting from this transaction represents the amount by which the purchase price exceeded the fair value of the net assets. In accordance with U.S. GAAP the Company evaluates goodwill periodically for impairment. There was no impairment recognized for the years ended December 31, 2013, 2012, and 2011.

Income Taxes

The Company files its income taxes on a consolidated basis with its subsidiary. The allocation of income tax expense represents each entity's proportionate share of the consolidated provision for income taxes.

Income taxes are accounted for using the asset and liability method. Under the asset and liability method, deferred taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred taxes of a change in tax rates would be recognized in income in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

The Company adopted guidance issued by the FASB *accounting for income taxes*, effective January 1, 2007, which clarifies the accounting and disclosure for uncertainty in tax positions as defined. This guidance seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely to be realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. We have determined that as of December 31, 2013 all tax positions taken to date are highly certain and, accordingly, no accounting adjustment has been made to the financial statements.

The Company recognizes interest and penalties related to uncertain tax positions as part of income tax expense.

#### Salary Continuation Agreements and Directors’ Retirement Plan

The Company has entered into agreements to provide members of the Board of Directors and certain key executives, or their designated beneficiaries, with annual benefits for up to fifteen years after retirement or death. The Company accrues for these future benefits from the effective date of the plan until the director’s or executive’s expected retirement date in a systematic and rational manner. At the consolidated balance sheet date, the amount of accrued benefits equals the then present value of the benefits expected to be provided to the director or employee, any beneficiaries, and covered dependents in exchange for the director’s or employee’s services to that date.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Comprehensive Income

Comprehensive income consists of net income and the net change in unrealized gains on securities available-for-sale, net of an adjustment for the effects of realized gains and losses and any applicable tax. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income that historically has not been recognized in the calculation of net income. Unrealized gains and losses on the Company's available-for-sale investment securities are included in other comprehensive income after adjusting for the effects of realized gains and losses. Total comprehensive income and the components of accumulated other comprehensive income (loss) are presented in the consolidated statements of comprehensive income.

##### Stock-Based Compensation

At December 31, 2013, the Company had one stock-based compensation plan, the Sierra Bancorp 2007 Stock Incentive Plan (the "2007 Plan"), which was adopted by the Company's Board of Directors on March 15, 2007 and approved by the Company's shareholders on May 23, 2007. The 2007 Plan is for 1,500,000 shares of the Company's authorized but unissued common stock, subject to adjustment for stock splits and dividends, and provides for the issuance of both "incentive" and "nonqualified" stock options to salaried officers and employees, and of "nonqualified" stock options to non-employee directors. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants. We have not issued, nor do we currently have plans to issue, restricted stock awards. The 2007 plan supersedes the Company's 1998 Stock Option plan ("1998 Plan") which was terminated. The outstanding options issued under the 1998 Plan were not affected by this termination.

The Company is using the Black-Scholes model to value stock options. The "multiple option" approach is used to allocate the resulting valuation to actual expense for current period. Expected volatility is based on historical volatility of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not

transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. The fair value of each option is estimated on the date of grant using the following assumptions:

|                         | Years Ended December 31, |           |           |   |
|-------------------------|--------------------------|-----------|-----------|---|
|                         | 2013 <sup>(a)</sup>      | 2012      | 2011      |   |
| Dividend yield          | N/A                      | 2.35      | % 2.27    | % |
| Expected Volatility     | N/A                      | 56.71     | % 52.92   | % |
| Risk-free interest rate | N/A                      | 0.43      | % 1.06    | % |
| Expected option life    | N/A                      | 5.5 years | 6.8 years |   |

<sup>(a)</sup> No stock options were issued in 2013.

**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Recent Accounting Pronouncements**

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, with the goal of improving the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income, by component. In addition, if the amount reclassified is required under U.S. Generally Accepted Accounting Principles (GAAP) to be reclassified to net income in its entirety in the same reporting period, an entity is required to present significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional detail about those amounts. For public entities, this update became effective prospectively for reporting periods beginning after December 15, 2012. We adopted ASU 2013-02 commencing with our report on Form 10-Q filed for the first quarter of 2013.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE**

The amortized cost and estimated fair value of investment securities available-for-sale are as follows (dollars in thousands):

|                                  | December 31, 2013 |                              |                               |                         |
|----------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
|                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
| US Government Agencies           | \$5,395           | \$18                         | \$(109)                       | \$5,304                 |
| Mortgage-backed securities       | 320,223           | 3,269                        | (2,771)                       | 320,721                 |
| State and political subdivisions | 97,361            | 1,723                        | (2,521)                       | 96,563                  |
| Equity securities                | 1,336             | 1,120                        | -                             | 2,456                   |
| Total investment securities      | \$424,315         | \$6,130                      | \$(5,401)                     | \$425,044               |

|                                  | December 31, 2012 |                              |                               |                         |
|----------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
|                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
| US Government Agencies           | \$2,987           | \$ 3                         | \$(17)                        | \$ 2,973                |
| Mortgage-backed securities       | 298,806           | 3,547                        | (964)                         | 301,389                 |
| State and political subdivisions | 70,736            | 3,430                        | (180)                         | 73,986                  |
| Equity securities                | 1,336             | 508                          | (4)                           | 1,840                   |
| Total investment securities      | \$373,865         | \$ 7,488                     | \$(1,165)                     | \$ 380,188              |

For the years ended December 31, 2013, 2012, and 2011, proceeds from sales of securities available-for-sale were \$700 thousand, \$56.4 million, and \$45.7 million, respectively. Gains and losses on the sale of investment securities are recorded on the trade date and are determined using the specific identification method.



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Gross gains and losses from the sales and calls of investment securities for the years ended were as follows (dollars in thousands):

|  | December 31, |         |
|--|--------------|---------|
|  | 2012         | 2011    |
| Gross Gains on Sales and Calls of Investment Securities  | \$6 \$2,059  | \$1,666 |
| Gross Losses on Sales and Calls of Investment Securities | - (297)      | (6)     |
| Net Gains on Sales and Calls of Investment Securities    | \$6 \$1,762  | \$1,660 |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE (Continued)**

At December 31, 2013 and 2012, the Company had 197 and 89 securities with unrealized gross losses, respectively. Information pertaining to these securities aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows (dollars in thousands):

|                                  | December 31, 2013       |            |                    |            |
|----------------------------------|-------------------------|------------|--------------------|------------|
|                                  | Less Than Twelve Months |            | Over Twelve Months |            |
|                                  | Gross                   | Gross      | Gross              | Gross      |
|                                  | Unrealized              | Fair Value | Unrealized         | Fair Value |
|                                  | Losses                  |            | Losses             |            |
| US Government Agencies           | \$(92)                  | \$ 1,913   | \$(17)             | \$ 1,920   |
| Mortgage-backed securities       | (642)                   | 21,747     | (2,129)            | 124,317    |
| State and political subdivisions | (461)                   | 6,799      | (2,060)            | 38,083     |
| Equity securities                | -                       | -          | -                  | -          |
| Total                            | \$(1,195)               | \$ 30,459  | \$(4,206)          | \$ 164,320 |

|                                  | December 31, 2012       |            |                    |            |
|----------------------------------|-------------------------|------------|--------------------|------------|
|                                  | Less Than Twelve Months |            | Over Twelve Months |            |
|                                  | Gross                   | Gross      | Gross              | Gross      |
|                                  | Unrealized              | Fair Value | Unrealized         | Fair Value |
|                                  | Losses                  |            | Losses             |            |
| US Government Agencies           | \$(17)                  | \$ 1,996   | \$ -               | \$ -       |
| Mortgage-backed securities       | (903)                   | 106,799    | (61)               | 6,965      |
| State and political subdivisions | (180)                   | 9,324      | -                  | -          |
| Equity securities                | (4)                     | 242        | -                  | -          |
| Total                            | \$(1,104)               | \$ 118,361 | \$( 61)            | \$ 6,965   |

The Company has reviewed all sectors and securities in the investment portfolio for impairment. During the year ended December 31, 2013, the Company realized slight gains and no losses from the sale of three debt securities which were sold to improve the credit quality of the portfolio by minimizing securities on our Municipal Bond Watch

List. During the year ended December 31, 2012 the Company realized losses through earnings from the sale of 22 debt securities for \$297,000. The securities were sold with 129 other debt securities for which \$2,059,000 in gains were realized, as a part of a liquidity strategy to fund new loan growth.

The Company has concluded as of December 31, 2013 that all remaining securities, currently in an unrealized loss position, are not other-than-temporarily-impaired. This assessment was based on the following factors: 1) the Company has the ability to hold the security, 2) the Company does not intend to sell the security, 3) the Company does not anticipate it will be required to sell the security before recovery, 4) and the Company expects to eventually recover the entire amortized cost basis of the security.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**3. INVESTMENT SECURITIES AVAILABLE-FOR-SALE (Continued)**

The amortized cost and estimated fair value of investment securities available-for-sale at December 31, 2013 by contractual maturity are shown below. 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 penalties.

|  | Amortized<br>Cost      | Fair Value |
|--|------------------------|------------|
|  | (dollars in thousands) |            |
| Maturing within one year                                       | \$ 2,294               | \$ 2,316   |
| Maturing after one year through five years                     | 241,396                | 242,493    |
| Maturing after five years through ten years                    | 59,572                 | 59,402     |
| Maturing after ten years                                       | 49,674                 | 47,737     |
| Investment securities not due at a single maturity date:       |                        |            |
| U.S Government agencies collateralized by mortgage obligations | 70,043                 | 70,640     |
| Other securities   | 1,336                  | 2,456      |
|  | \$ 424,315             | \$ 425,044 |

Investment securities available-for-sale with amortized costs totaling \$162,393,000 and estimated fair values totaling \$164,390,000 were pledged to secure other contractual obligations and short-term borrowing arrangements at December 31, 2013. (see Note 8)

Investment securities available-for-sale with amortized costs totaling \$174,930,000 and estimated fair values totaling \$178,550,000 were pledged to secure public deposits, other contractual obligations and short-term borrowing arrangements at December 31, 2012. (see Note 8)

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES**

The composition of the loan and lease portfolio is as follows (dollars in thousands):

|   | December 31,     |                  |
|---|------------------|------------------|
|   | 2013             | 2012             |
| Real estate:  |                  |                  |
| Secured by residential, commercial and professional office properties, including construction and development | \$318,383        | \$303,424        |
| Secured by residential properties   | 150,952          | 170,514          |
| Secured by farm land  | 108,504          | 71,851           |
| <b>Total Real Estate Loans</b>  | <b>577,839</b>   | <b>545,789</b>   |
| Agricultural  | 25,180           | 22,482           |
| Commercial and industrial   | 158,756          | 257,896          |
| Small Business Administration loans   | 14,905           | 20,523           |
| Direct Financing leases   | 3,026            | 4,233            |
| Consumer  | 23,536           | 28,872           |
| <b>Total Loans</b>  | <b>803,242</b>   | <b>879,795</b>   |
| Deferred loan and lease origination cost, net   | 1,522            | 1,156            |
| Allowance for loan and lease losses   | (11,677)         | (13,873)         |
| <b>Loans, net</b>   | <b>\$793,087</b> | <b>\$867,078</b> |

The Company monitors the credit quality of loans on a continuous basis using the regulatory and accounting classifications of pass, special mention, substandard and impaired to characterize and qualify the associated credit risk. Loans classified as "loss" are immediately charged-off. The Company uses the following definitions of risk classifications:

**Pass** Loans listed as pass include larger non-homogeneous loans not meeting the risk rating definitions below and smaller, homogeneous loans not assessed on an individual basis.

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

**Substandard** Loans classified as substandard are those loans with clear and well-defined weaknesses such as a highly leveraged position, unfavorable financial operating results and/or trends, or uncertain repayment sources or poor financial condition, which may jeopardize ultimate recoverability of the debt.

**Impaired** A loan is considered impaired, when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Additionally, all loans classified as troubled debt restructurings are considered impaired.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

Credit quality classifications as of December 31, 2013 were as follows (dollars in thousands):

|   | Pass           | Special<br>Mention | Substandard  | Impaired      | Total          |
|---|----------------|--------------------|--------------|---------------|----------------|
| Real Estate:                              |                |                    |              |               |                |
| 1-4 family residential construction       | \$ 1,720       | \$-                | \$ -         | \$-           | \$ 1,720       |
| Other Construction/Land                   | 18,243         | 334                | 203          | 6,751         | 25,531         |
| 1-4 family - closed-end                   | 67,051         | 1,305              | 770          | 17,898        | 87,024         |
| Equity Lines                              | 51,019         | 254                | 1,429        | 1,021         | 53,723         |
| Multi-family residential                  | 8,059          | 426                | -            | -             | 8,485          |
| Commercial real estate owner occupied     | 158,155        | 17,033             | 3,261        | 7,563         | 186,012        |
| Commercial real estate Non-owner occupied | 89,475         | 3,630              | 240          | 13,495        | 106,840        |
| Farmland                                  | 105,623        | 1,780              | 819          | 282           | 108,504        |
| <br>Total Real Estate                     | <br>499,345    | <br>24,762         | <br>6,722    | <br>47,010    | <br>577,839    |
| <br>Agricultural                          | <br>24,178     | <br>532            | <br>-        | <br>470       | <br>25,180     |
| Commercial and Industrial                 | 153,125        | 2,520              | 416          | 2,695         | 158,756        |
| Small Business Administration loans       | 10,498         | 838                | 820          | 2,749         | 14,905         |
| Direct finance leases                     | 3,026          | -                  | -            | -             | 3,026          |
| Consumer loans                            | 19,387         | 478                | 208          | 3,463         | 23,536         |
| <br>Total Gross Loans and Leases          | <br>\$ 709,559 | <br>\$ 29,130      | <br>\$ 8,166 | <br>\$ 56,387 | <br>\$ 803,242 |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

Credit quality classifications as of December 31, 2012 were as follows (dollars in thousands):

|   | Pass              | Special<br>Mention | Substandard      | Impaired         | Total             |
|---|-------------------|--------------------|------------------|------------------|-------------------|
| Real Estate:                              |                   |                    |                  |                  |                   |
| 1-4 family residential construction       | \$ 1,599          | \$ 1,333           | \$ 89            | \$ 153           | \$ 3,174          |
| Other Construction/Land                   | 13,270            | 952                | 1,132            | 12,648           | 28,002            |
| 1-4 family - closed-end                   | 73,002            | 2,484              | 1,209            | 23,222           | 99,917            |
| Equity Lines                              | 58,161            | 95                 | 1,949            | 1,258            | 61,463            |
| Multi-family residential                  | 5,351             | 609                | -                | -                | 5,960             |
| Commercial real estate owner occupied     | 144,207           | 22,895             | 6,562            | 8,950            | 182,614           |
| Commercial real estate Non-owner occupied | 67,407            | 6,864              | 568              | 17,969           | 92,808            |
| Farmland                                  | 64,176            | 2,216              | 3,526            | 1,933            | 71,851            |
| <b>Total Real Estate</b>                  | <b>427,173</b>    | <b>37,448</b>      | <b>15,035</b>    | <b>66,133</b>    | <b>545,789</b>    |
| Agricultural                              | 21,333            | 462                | 24               | 663              | 22,482            |
| Commercial and Industrial                 | 247,375           | 5,020              | 1,845            | 3,656            | 257,896           |
| Small Business Administration loans       | 15,002            | 1,551              | 743              | 3,227            | 20,523            |
| Direct finance leases                     | 4,076             | 22                 | -                | 135              | 4,233             |
| Consumer loans                            | 23,881            | 445                | 198              | 4,348            | 28,872            |
| <b>Total Gross Loans and Leases</b>       | <b>\$ 738,840</b> | <b>\$ 44,948</b>   | <b>\$ 17,845</b> | <b>\$ 78,162</b> | <b>\$ 879,795</b> |



**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

A summary of the transactions in the allowance for loan and lease losses follows (dollars in thousands):

|                                     | Year Ended December 31, |          |          |
|-------------------------------------|-------------------------|----------|----------|
|                                     | 2013                    | 2012     | 2011     |
| Balance, beginning of year          | \$13,873                | \$17,283 | \$21,138 |
| Provision for loan and lease losses | 4,350                   | 14,210   | 12,000   |
| Losses charged to allowance         | (8,263)                 | (18,778) | (16,987) |
| Recoveries                          | 1,717                   | 1,158    | 1,132    |
| Balance, end of year                | \$11,677                | \$13,873 | \$17,283 |

Loans may or may not be collateralized, and collection efforts are continuously pursued. Loans or leases may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Loans and leases are charged off when they are deemed to be uncollectible, while recoveries are generally recorded only when cash payments are received subsequent to the charge-off.

The following table presents the activity in the allowance for loan losses for the year 2013 and the recorded investment in loans and impairment method as of December 31, 2013 by portfolio segment (dollars in thousands):

|                              | Commercial<br>and<br>Agricultural |        | Industrial | Administration | Direct<br>Small Business<br>Finance<br>Leases | Consumer | Unallocated | Total     |
|------------------------------|-----------------------------------|--------|------------|----------------|---|----------|-------------|-----------|
|                              | Real Estate                       |        |            |                |   |          |             |           |
| Allowance for credit losses: |                                   |        |            |                |   |          |             |           |
| Beginning of year            | \$ 8,034                          | \$ 258 | \$ 2,056   | \$ 1,246       | \$ 165  | \$ 2,114 | \$ -        | \$ 13,873 |
| Charge-offs                  | (4,205)                           | (473)  | (1,268)    | (294)          | (106)   | (1,917)  | -           | (8,263)   |
| Recoveries                   | 618                               | -      | 747        | 37             | 18  | 297      | -           | 1,717     |

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|                                    |           |           |            |           |          |           |        |           |
|------------------------------------|-----------|-----------|------------|-----------|----------|-----------|--------|-----------|
| Provision                          | 1,097     | 1,193     | 633        | 626       | (73)     | 623       | 251    | 4,350     |
| End of year                        | \$5,544   | \$ 978    | \$ 2,168   | \$ 1,615  | \$4      | \$ 1,117  | \$ 251 | \$11,677  |
| Reserves:                          |           |           |            |           |          |           |        |           |
| Specific                           | \$2,867   | \$ 126    | \$ 655     | \$ 1,270  | \$-      | \$431     | \$ -   | \$5,349   |
| General                            | 2,677     | 852       | 1,513      | 345       | 4        | 686       | 251    | 6,328     |
|                                    | \$5,544   | \$ 978    | \$ 2,168   | \$ 1,615  | \$4      | \$ 1,117  | \$ 251 | \$11,677  |
| Loans evaluated for<br>impairment: |           |           |            |           |          |           |        |           |
| Individually                       | \$47,010  | \$ 470    | \$ 2,695   | \$ 2,749  | \$-      | \$ 3,463  | \$ -   | \$56,387  |
| Collectively                       | 530,829   | 24,710    | 156,061    | 12,156    | 3,026    | 20,073    | -      | 746,855   |
|                                    | \$577,839 | \$ 25,180 | \$ 158,756 | \$ 14,905 | \$ 3,026 | \$ 23,536 | \$ -   | \$803,242 |

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

The following table presents the activity in the allowance for loan losses for the year 2012 and the recorded investment in loans and impairment method as of December 31, 2012 by portfolio segment (dollars in thousands):

|                                 | Real Estate | Agricultural | Commercial<br>and<br>Industrial | Small Business<br>Administration | Direct<br>Finance<br>Leases | Consumer  | Unallocated | Total      |
|---------------------------------|-------------|--------------|---------------------------------|----------------------------------|-----------------------------|-----------|-------------|------------|
| Allowance for credit losses:    |             |              |                                 |                                  |                             |           |             |            |
| Beginning of year               | \$ 8,260    | \$ 19        | \$ 4,638                        | \$ 1,447                         | \$ 311                      | \$ 2,608  | \$ -        | \$ 17,283  |
| Charge-offs                     | (11,108)    | (634)        | (3,517)                         | (753)                            | (198)                       | (2,568)   | -           | (18,778)   |
| Recoveries                      | 302         | -            | 483                             | 95                               | -                           | 278       | -           | 1,158      |
| Provision                       | 10,580      | 873          | 452                             | 457                              | 52                          | 1,796     | -           | 14,210     |
| End of year                     | \$ 8,034    | \$ 258       | \$ 2,056                        | \$ 1,246                         | \$ 165                      | \$ 2,114  | \$ -        | \$ 13,873  |
| Reserves:                       |             |              |                                 |                                  |                             |           |             |            |
| Specific                        | \$ 4,180    | \$ 28        | \$ 934                          | \$ 1,038                         | \$ 67                       | \$ 878    | \$ -        | \$ 7,125   |
| General                         | 3,854       | 230          | 1,122                           | 208                              | 98                          | 1,236     | -           | 6,748      |
|                                 | \$ 8,034    | \$ 258       | \$ 2,056                        | \$ 1,246                         | \$ 165                      | \$ 2,114  | \$ -        | \$ 13,873  |
| Loans evaluated for impairment: |             |              |                                 |                                  |                             |           |             |            |
| Individually                    | \$ 66,133   | \$ 663       | \$ 3,656                        | \$ 3,227                         | \$ 135                      | \$ 4,348  | \$ -        | \$ 78,162  |
| Collectively                    | 479,656     | 21,819       | 254,240                         | 17,296                           | 4,098                       | 24,524    | -           | 801,633    |
|                                 | \$ 545,789  | \$ 22,482    | \$ 257,896                      | \$ 20,523                        | \$ 4,233                    | \$ 28,872 | \$ -        | \$ 879,795 |

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

Past due and nonaccrual loans as of December 31, 2013 were as follows (dollars in thousands):

|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days Or<br>More Past Due <sup>(1)</sup> | Total Past Due | Current    | Total Financing<br>Receivables | Non-Accrual<br>Loans <sup>(2)</sup> |
|--|------------------------|------------------------|--|----------------|------------|--------------------------------|-------------------------------------|
| Real Estate:                                 |                        |                        |  |                |            |                                |                                     |
| 1-4 family residential<br>construction       | \$ -                   | \$ -                   | \$ -                                       | \$ -           | \$ 1,720   | \$ 1,720                       | \$ -                                |
| Other Construction/Land                      | 294                    | -                      | 116  | 410            | 25,121     | 25,531                         | 5,528                               |
| 1-4 family - closed-end                      | 2,181                  | 300                    | 171  | 2,652          | 84,372     | 87,024                         | 13,168                              |
| Equity Lines                                 | 98                     | -                      | 288  | 386            | 53,337     | 53,723                         | 778                                 |
| Multi-family residential                     | -                      | -                      | -  | -              | 8,485      | 8,485                          | -                                   |
| Commercial real estate<br>owner occupied     | 1,917                  | 144                    | 2,011                                      | 4,072          | 181,940    | 186,012                        | 5,516                               |
| Commercial real estate<br>Non-owner occupied | -                      | -                      | 7,667                                      | 7,667          | 99,173     | 106,840                        | 8,058                               |
| Farmland                                     | 331                    | -                      | -  | 331            | 108,173    | 108,504                        | 282                                 |
| Total Real Estate<br>Loans                   | 4,821                  | 444                    | 10,253                                     | 15,518         | 562,321    | 577,839                        | 33,330                              |
| Agricultural                                 | 892                    | 327                    | 125  | 1,344          | 23,836     | 25,180                         | 470                                 |
| Commercial and Industrial                    | 342                    | 78                     | 24   | 444            | 158,312    | 158,756                        | 685                                 |
| Small Business<br>Administration Loans       | 976                    | 509                    | 1,274                                      | 2,759          | 12,146     | 14,905                         | 1,937                               |
| Direct finance leases                        | -                      | -                      | -  | -              | 3,026      | 3,026                          | -                                   |
| Consumer loans                               | 181                    | -                      | -  | 181            | 23,355     | 23,536                         | 992                                 |
| Total Gross Loans and<br>Leases              | \$ 7,212               | \$ 1,358               | \$ 11,676                                  | \$ 20,246      | \$ 782,996 | \$ 803,242                     | \$ 37,414                           |

<sup>(1)</sup> As of December 31, 2013 there were no loans over 90 days past due and still accruing.

(2) Included in Total Financing Receivables

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## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

Past due and nonaccrual loans as of December 31, 2012 were as follows (dollars in thousands):

|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days Or More<br>Past Due <sup>(1)</sup> | Total Past Due | Current   | Total Financing<br>Receivables | Non-Accrual<br>Loans <sup>(2)</sup> |
|--|------------------------|------------------------|--|----------------|-----------|--------------------------------|-------------------------------------|
| Real Estate:                                 |                        |                        |  |                |           |                                |                                     |
| 1-4 family residential<br>construction       | \$ -                   | \$ -                   | \$ 153                                     | \$ 153         | \$3,021   | \$ 3,174                       | \$ 153                              |
| Other Construction/Land                      | 374                    | 211                    | -  | 585            | 27,417    | 28,002                         | 11,163                              |
| 1-4 family - closed-end                      | 1,335                  | 88                     | 376  | 1,799          | 98,117    | 99,916                         | 15,381                              |
| Equity Lines                                 | 473                    | 40                     | 66   | 579            | 60,885    | 61,464                         | 1,026                               |
| Multi-family residential                     | 177                    | -                      | -  | 177            | 5,783     | 5,960                          | -                                   |
| Commercial real estate<br>owner occupied     | 1,372                  | 813                    | 1,289                                      | 3,474          | 179,140   | 182,614                        | 5,314                               |
| Commercial real estate<br>Non-owner occupied | 7,831                  | -                      | 1,499                                      | 9,330          | 83,478    | 92,808                         | 11,642                              |
| Farmland                                     | 231                    | -                      | 1,679                                      | 1,910          | 69,941    | 71,851                         | 1,933                               |
| Total Real Estate<br>Loans                   | 11,793                 | 1,152                  | 5,062                                      | 18,007         | 527,782   | 545,789                        | 46,612                              |
| Agricultural                                 | 24                     | 157                    | 506  | 687            | 21,795    | 22,482                         | 664                                 |
| Commercial and Industrial                    | 1,419                  | 518                    | 7  | 1,944          | 255,952   | 257,896                        | 2,386                               |
| Small Business<br>Administration Loans       | 905                    | -                      | 1,574                                      | 2,479          | 18,044    | 20,523                         | 2,159                               |
| Direct finance leases                        | -                      | 34                     | 123  | 157            | 4,076     | 4,233                          | 135                                 |
| Consumer loans                               | 238                    | 189                    | 87   | 514            | 28,358    | 28,872                         | 1,138                               |
| Total Gross Loans and<br>Leases              | \$ 14,379              | \$ 2,050               | \$ 7,359                                   | \$ 23,788      | \$856,007 | \$ 879,795                     | \$ 53,094                           |

<sup>(1)</sup> As of December 31, 2012 there were no loans over 90 days past due and still accruing.<sup>(2)</sup> Included in Total Financing Receivables

Generally, the Company places a loan or lease on nonaccrual status and ceases recognizing interest income when it has become delinquent more than 90 days and/or when Management determines that the repayment of principal and collection of interest is unlikely. The Company may decide that it is appropriate to continue to accrue interest on certain loans more than 90 days delinquent if they are well-secured by collateral and collection is in process. When a loan is placed on nonaccrual status, any accrued but uncollected interest for the loan is reversed out of interest income in the period in which the loan's status changed. Subsequent payments received from the customer are applied to principal, and no further interest income is recognized until the principal has been paid in full or until circumstances have changed such that payments are again consistently received as contractually required.

The following is a summary of information pertaining to impaired and non-accrual loans (dollars in thousands):

|   | Years Ended December 31, |           |
|---|--------------------------|-----------|
|   | 2013                     | 2012      |
| Impaired loans without a valuation allowance                | \$ 25,722                | \$ 14,292 |
| Impaired loans with a valuation allowance                   | 30,665                   | 63,870    |
| Total impaired loans <sup>(1)</sup>                         | \$ 56,387                | \$ 78,162 |
| Valuation allowance related to impaired loans               | \$ 5,349                 | \$ 7,125  |
| Total non-accrual loans                                     | \$ 37,414                | \$ 53,094 |
| Total loans past-due ninety days or more and still accruing | \$ -                     | \$ -      |

<sup>(1)</sup> Principal balance only

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

Individually impaired loans as of December 31, 2013 were as follows (dollars in thousands):

|  | Year Ended December 31, 2013                  |                                       |                      |                                   |   |
|--|---|---------------------------------------|----------------------|-----------------------------------|---|
|  | Unpaid<br>Principal<br>Balance <sup>(1)</sup> | Recorded<br>Investment <sup>(2)</sup> | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized <sup>(3)</sup> |
| With an Allowance Recorded                 |   |                                       |                      |                                   |   |
| Real Estate:                               |   |                                       |                      |                                   |   |
| 1-4 family residential construction        | \$-   | \$ -                                  | \$ -                 | \$ -                              | \$ -  |
| Other Construction/Land                    | 2,972   | 2,972                                 | 502                  | 3,000                             | 98  |
| 1-4 Family - closed-end                    | 13,522  | 13,522                                | 1,324                | 13,630                            | 260   |
| Equity Lines                               | 528   | 528                                   | 123                  | 530                               | 13  |
| Multifamily residential                    | -   | -                                     | -                    | -                                 | -   |
| Commercial real estate- owner occupied     | 2,047   | 2,047                                 | 217                  | 2,069                             | 135   |
| Commercial real estate- non-owner occupied | 3,715   | 3,715                                 | 701                  | 3,813                             | 238   |
| Farmland                                   | -   | -                                     | -                    | -                                 | -   |
| Total Real Estate                          | 22,784  | 22,784                                | 2,867                | 23,042                            | 744   |
| Agricultural                               | 125   | 125                                   | 126                  | 131                               | -   |
| Commercial and Industrial                  | 1,870   | 1,857                                 | 655                  | 2,009                             | 85  |
| Small Business Administration              | 2,710   | 2,488                                 | 1,270                | 2,487                             | 46  |
| Direct finance leases                      | -   | -                                     | -                    | -                                 | -   |
| Consumer loans                             | 3,411   | 3,411                                 | 431                  | 3,591                             | 172   |
|  | 30,900  | 30,665                                | 5,349                | 31,260                            | 1,047   |
| With no Related Allowance Recorded         |   |                                       |                      |                                   |   |
| Real Estate:                               |   |                                       |                      |                                   |   |
| 1-4 family residential construction        | \$-   | \$ -                                  | \$ -                 | \$ -                              | \$ -  |
| Other Construction/Land                    | 4,176   | 3,779                                 | -                    | 3,885                             | -   |
| 1-4 Family - closed-end                    | 4,655   | 4,376                                 | -                    | 4,687                             | 1   |
| Equity Lines                               | 565   | 493                                   | -                    | 493                               | -   |
| Multifamily residential                    | -   | -                                     | -                    | -                                 | -   |
| Commercial real estate- owner occupied     | 7,436   | 5,516                                 | -                    | 5,568                             | -   |
| Commercial real estate- non-owner occupied | 10,077  | 9,780                                 | -                    | 9,820                             | 115   |
| Farmland                                   | 282   | 282                                   | -                    | 290                               | -   |



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|                               |          |           |          |           |          |
|-------------------------------|----------|-----------|----------|-----------|----------|
| Total Real Estate             | 27,191   | 24,226    | -        | 24,743    | 116      |
| Agricultural                  | 345      | 345       | -        | 837       | -        |
| Commercial and Industrial     | 891      | 838       | -        | 1,346     | 57       |
| Small Business Administration | 358      | 261       | -        | 261       | -        |
| Direct finance leases         | -        | -         | -        | -         | -        |
| Consumer loans                | 241      | 52        | -        | 77        | -        |
|                               | 29,026   | 25,722    | -        | 27,264    | 173      |
| Total                         | \$59,926 | \$ 56,387 | \$ 5,349 | \$ 58,524 | \$ 1,220 |

<sup>(1)</sup>Contractual principal balance due from customer.

<sup>(2)</sup>Principal balance on Company's books, less any direct charge offs.

<sup>(3)</sup>Interest income is recognized on performing balances on a regular accrual basis.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

Individually impaired loans as of December 31, 2012 were as follows (dollars in thousands):

|  | Year Ended December 31, 2012                  |                                       |                      |                                   |   |
|--|---|---------------------------------------|----------------------|-----------------------------------|---|
|  | Unpaid<br>Principal<br>Balance <sup>(1)</sup> | Recorded<br>Investment <sup>(2)</sup> | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized <sup>(3)</sup> |
| With an Allowance Recorded                 |   |                                       |                      |                                   |   |
| Real Estate:                               |   |                                       |                      |                                   |   |
| 1-4 family residential construction        | \$ 153  | \$ 153                                | \$ 23                | \$ 91                             | \$ -  |
| Other Construction/Land                    | 10,313  | 10,313                                | 1,244                | 10,755                            | 86  |
| 1-4 Family - closed-end                    | 19,218  | 18,910                                | 955                  | 19,024                            | 401   |
| Equity Lines                               | 1,142   | 1,142                                 | 163                  | 1,144                             | 9   |
| Multifamily residential                    | -   | -                                     | -                    | -                                 | -   |
| Commercial real estate- owner occupied     | 5,846   | 5,585                                 | 563                  | 5,666                             | 126   |
| Commercial real estate- non-owner occupied | 18,539  | 17,579                                | 1,230                | 18,079                            | 481   |
| Farmland                                   | 254   | 254                                   | 2                    | 259                               | -   |
| Total Real Estate                          | 55,465  | 53,936                                | 4,180                | 55,018                            | 1,103   |
| Agricultural                               | 28  | 28                                    | 28                   | 28                                | -   |
| Commercial and Industrial                  | 2,955   | 2,920                                 | 934                  | 3,100                             | 51  |
| Small Business Administration              | 2,704   | 2,507                                 | 1,038                | 2,507                             | 53  |
| Direct finance leases                      | 135   | 135                                   | 67                   | 135                               | -   |
| Consumer loans                             | 4,349   | 4,344                                 | 878                  | 4,493                             | 183   |
|  | 65,636  | 63,870                                | 7,125                | 65,281                            | 1,390   |
| With no Related Allowance Recorded         |   |                                       |                      |                                   |   |
| Real Estate:                               |   |                                       |                      |                                   |   |
| 1-4 family residential construction        | \$ -  | \$ -                                  | \$ -                 | \$ -                              | \$ -  |
| Other Construction/Land                    | 2,335   | 2,335                                 | -                    | 2,346                             | -   |
| 1-4 Family - closed-end                    | 4,312   | 4,312                                 | -                    | 4,491                             | -   |
| Equity Lines                               | 116   | 116                                   | -                    | 155                               | 1   |
| Multifamily residential                    | -   | -                                     | -                    | -                                 | -   |
| Commercial real estate- owner occupied     | 4,298   | 3,365                                 | -                    | 3,540                             | -   |
| Commercial real estate- non-owner occupied | 390   | 390                                   | -                    | 421                               | 3   |
| Farmland                                   | 1,679   | 1,679                                 | -                    | 1,686                             | -   |

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|                               |          |           |          |           |          |
|-------------------------------|----------|-----------|----------|-----------|----------|
| Total Real Estate             | 13,130   | 12,197    | -        | 12,639    | 4        |
| Agricultural                  | 1,008    | 635       | -        | 1,017     | -        |
| Commercial and Industrial     | 735      | 736       | -        | 740       | -        |
| Small Business Administration | 1,008    | 720       | -        | 720       | -        |
| Direct finance leases         | -        | -         | -        | -         | -        |
| Consumer loans                | 4        | 4         | -        | 7         | -        |
|                               | 15,885   | 14,292    | -        | 15,123    | 4        |
| Total                         | \$81,521 | \$ 78,162 | \$ 7,125 | \$ 80,404 | \$ 1,394 |

<sup>(1)</sup>Contractual principal balance due from customer.

<sup>(2)</sup>Principal balance on Company's books, less any direct charge offs.

<sup>(3)</sup>Interest income is recognized on performing balances on a regular accrual basis.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

Included in loans above are troubled debt restructurings that were classified as impaired. The Company had \$3,714,000 and \$3,427,000 in commercial loans, \$32,960,000 and \$40,639,000 in real estate secured loans and \$3,250,000 and \$3,976,000 in consumer loans, which were modified as troubled debt restructurings and consequently classified as impaired at December 31, 2013 and 2012, respectively.

Additional commitments to existing customers with restructured loans totaled \$250,000 and \$195,000 at December 31, 2013 and 2012 respectively.

Interest income recognized on impaired loans was \$1,220,000, \$1,394,000, and \$1,214,000 for the years ended December 31, 2013, 2012 and 2011 respectively. There was no interest income recognized on a cash basis on impaired loans for the years ended December 31, 2013, 2012 and 2011 respectively.

The following is a summary of interest income from non-accrual loans in the portfolio at year-end that was not recognized (dollars in thousands):

|  | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2013                     | 2012     | 2011     |
| Interest that would have been recorded under the loans' original terms | \$ 3,209                 | \$ 4,084 | \$ 4,353 |
| Less gross interest recorded   | 304                      | 2,088    | 1,328    |
| Foregone interest  | \$ 2,905                 | \$ 1,996 | \$ 3,025 |

Certain loans have been pledged to secure short-term borrowing arrangements (see Note 8). These loans totaled \$413,369,000 and \$392,644,000 at December 31, 2013 and 2012, respectively.

Salaries and employee benefits totaling \$2,804,000, \$2,745,000, and \$2,586,000, have been deferred as loan and lease origination costs to be amortized over the estimated lives of the related loans and leases for the years ended December 31, 2013, 2012 and 2011, respectively.

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

During the periods ended December 31, 2013 and 2012, the terms of certain loans were modified as troubled debt restructurings. Types of modifications applied to these loans, include a reduction of the stated interest rate, a modification of term, an agreement to collect only interest rather than principal and interest for a specified period, or any combination thereof.

The following table presents troubled debt restructurings by type of modification during the period ending December 31, 2013 (dollars in thousands):

|  | Rate<br>Modification | Term<br>Modification | Interest Only<br>Modification | Rate & Term<br>Modification | Rate &<br>Interest Only<br>Modification | Term &<br>Interest Only<br>Modification | Rate, Term<br>& Interest<br>Only<br>Modification | Total |
|--|----------------------|----------------------|-------------------------------|-----------------------------|---|---|--|-------|
| Troubled Debt Restructurings                 |                      |                      |                               |                             |   |   |  |       |
| Real Estate:                                 |                      |                      |                               |                             |   |   |  |       |
| Other Construction/Land                      | \$ -                 | \$ 416               | \$ -                          | \$ -                        | \$ -                                    | \$ -                                    | \$ -   | \$416 |
| 1-4 family - closed-end                      | -                    | 3,338                | -                             | 238                         | -                                       | -                                       | 102  | 3,678 |
| Equity Lines                                 | -                    | -                    | 40                            | -                           | -                                       | -                                       | -  | 40    |
| Commercial real estate<br>owner occupied     | -                    | -                    | -                             | 557                         | -                                       | -                                       | -  | 557   |
| Commercial real estate<br>Non-owner occupied | -                    | -                    | -                             | -                           | -                                       | -                                       | -  | -     |
| Total Real Estate<br>Loans                   | -                    | 3,754                | 40                            | 795                         | -                                       | -                                       | 102  | 4,691 |
| Agricultural                                 | -                    | -                    | -                             | -                           | -                                       | -                                       | -  | -     |
| Commercial and Industrial                    | -                    | 1,563                | -                             | 308                         | -                                       | -                                       | -  | 1,871 |
| Consumer Loans                               | -                    | 469                  | -                             | -                           | -                                       | -                                       | 92   | 561   |
| Small Business<br>Administration loans       | -                    | -                    | -                             | -                           | -                                       | -                                       | -  | -     |

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\$ - \$ 5,786 \$ 40 \$ 1,103 \$ - \$ - \$ 194 \$7,123

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 4. LOANS AND LEASES (Continued)

The following table presents troubled debt restructurings by type of modification during the period ending December 31, 2012 (dollars in thousands):

|  | Rate<br>Modification | Term<br>Modification | Interest On<br>Modification | Rate & Term<br>Modification | Rate &<br>Interest Only<br>Modification | Term &<br>Interest Only<br>Modification | Rate, Term<br>& Interest<br>Only<br>Modification | Total   |
|--|----------------------|----------------------|-----------------------------|-----------------------------|---|---|--|---------|
| Troubled Debt Restructurings                 |                      |                      |                             |                             |   |   |  |         |
| Real Estate:                                 |                      |                      |                             |                             |   |   |  |         |
| Other Construction/Land                      | \$ -                 | \$ 458               | \$ -                        | \$ 375                      | \$ -                                    | \$ -                                    | \$ -   | \$833   |
| 1-4 family - closed-end                      | -                    | 313                  | -                           | 200                         | -                                       | 222                                     | 616  | 1,351   |
| Equity Lines                                 | -                    | 29                   | -                           | -                           | -                                       | -                                       | -  | 29      |
| Commercial real estate<br>owner occupied     | -                    | 1,006                | -                           | 1,184                       | -                                       | -                                       | -  | 2,190   |
| Commercial real estate<br>Non-owner occupied | -                    | 330                  | -                           | 60                          | -                                       | -                                       | -  | 390     |
| Total Real Estate<br>Loans                   | -                    | 2,136                | -                           | 1,819                       | -                                       | 222                                     | 616  | 4,793   |
| Agricultural                                 | -                    | -                    | -                           | -                           | -                                       | -                                       | -  | -       |
| Commercial and Industrial                    | -                    | 625                  | 2                           | 658                         | -                                       | -                                       | -  | 1,285   |
| Consumer Loans                               | -                    | 1,328                | -                           | 269                         | -                                       | -                                       | 117  | 1,714   |
| Small Business<br>Administration loans       | -                    | 200                  | -                           | 475                         | -                                       | -                                       | -  | 675     |
|  | \$ -                 | \$ 4,289             | \$ 2                        | \$ 3,221                    | \$ -                                    | \$ 222                                  | \$ 733   | \$8,467 |



**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

The following tables present loans by class modified as troubled debt restructurings including any subsequent defaults during the period ending December 31, 2013 (dollars in thousands):

|   | Number of<br>Loans | Pre-<br>Outstanding<br>Recorded<br>Investment | Post-<br>Outstanding<br>Recorded<br>Investment | Reserve<br>Difference <sup>(1)</sup> |
|---|--------------------|---|--|--------------------------------------|
| Real Estate:                              |                    |   |  |                                      |
| Other Construction/Land                   | 2                  | \$ 418  | \$ 416   | \$ 38                                |
| 1-4 family - closed-end                   | 8                  | 3,679   | 3,678  | 20                                   |
| Equity Lines                              | 1                  | 40  | 40   | 40                                   |
| Commercial real estate owner occupied     | 1                  | 557   | 557  | -                                    |
| Commercial real estate non-owner occupied | 0                  | -   | -  | -                                    |
| Total Real Estate Loans                   |                    | 4,694   | 4,691  | 98                                   |
| Agricultural                              | 0                  | -   | -  | -                                    |
| Commercial and Industrial                 | 8                  | 1,858   | 1,871  | 257                                  |
| Consumer Loans                            | 13                 | 561   | 561  | 54                                   |
| Small Business Administration loans       | 0                  | -   | -  | -                                    |
|   |                    | \$ 7,113                                      | \$ 7,123                                       | \$ 409                               |

<sup>(1)</sup> This represents the increase or (decrease) in the allowance for loans and lease losses reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

|                         | Number of Loans | Subsequent Defaults<br>Recorded<br>Investment | Charge-Offs |
|-------------------------|-----------------|---|-------------|
| Real Estate:            |                 |   |             |
| Other Construction/Land | 2               | \$ 162  | \$ 47       |

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|  |   |         |       |
|--|---|---------|-------|
| 1-4 family - closed-end                    | 2 | 779     | 133   |
| Equity Lines                               | 0 | -       | -     |
| Commercial real estate- owner occupied     | 1 | 308     | 245   |
| Commercial real estate- non owner occupied | 0 | -       | -     |
| Total Real Estate Loans                    |   | 1,249   | 425   |
| Agricultural                               | 0 | -       | -     |
| Commercial and Industrial                  | 7 | 374     | 373   |
| Consumer Loans                             | 7 | 181     | 132   |
| Small Business Administration Loans        | 2 | 194     | -     |
|  |   | \$1,998 | \$930 |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

The following tables present loans by class modified as troubled debt restructurings including any subsequent defaults during the period ending December 31, 2012 (dollars in thousands):

|  | Number of<br>Loans | Pre-<br>Outstanding<br>Recorded<br>Investment | Post-<br>Outstanding<br>Recorded<br>Investment | Reserve<br>Difference <sup>(1)</sup> |
|--|--------------------|---|--|--------------------------------------|
| Real Estate:                                 |                    |   |  |                                      |
| Other Construction/Land                      | 10                 | \$ 835  | \$ 833   | \$ 48                                |
| 1-4 family - closed-end                      | 11                 | 1,365   | 1,351  | 101                                  |
| Equity Lines                                 | 1                  | 29  | 29   | 13                                   |
| Commercial real estate owner occupied        | 6                  | 1,857   | 2,190  | (45)                                 |
| Commercial real estate non-owner<br>occupied | 3                  | 390   | 390  | 6                                    |
| Total Real Estate Loans                      |                    | 4,476   | 4,793  | 123                                  |
| Agricultural                                 | 0                  | -   | -  | -                                    |
| Commercial and Industrial                    | 20                 | 1,295   | 1,285  | 109                                  |
| Consumer Loans                               | 37                 | 1,723   | 1,714  | 21                                   |
| Small Business Administration loans          | 2                  | 668   | 675  | 8                                    |
|  |                    | \$ 8,162                                      | \$ 8,467                                       | \$ 261                               |

<sup>(1)</sup> This represents the increase or (decrease) in the allowance for loans and lease losses reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

|              | Subsequent Defaults |            |             |
|--------------|---------------------|------------|-------------|
|              | Recorded            | Investment | Charge-Offs |
| Real Estate: | Number of Loans     |            |             |

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|  |   |        |       |
|--|---|--------|-------|
| Other Construction/Land                    | 0 | \$ -   | \$ -  |
| 1-4 family - closed-end                    | 1 | 222    | -     |
| Equity Lines                               | 0 | -      | -     |
| Commercial real estate- owner occupied     | 1 | 332    | -     |
| Commercial real estate- non owner occupied | 0 | -      | -     |
| Total Real Estate Loans                    |   | 554    | -     |
| Agricultural                               | 0 | -      | -     |
| Commercial and Industrial                  | 1 | 66     | 66    |
| Consumer Loans                             | 2 | 115    | -     |
| Small Business Administration Loans        | 0 | -      | -     |
|  |   | \$ 735 | \$ 66 |

In the tables above, the TDRs that subsequently defaulted increased the allowance for loan and lease losses by \$660,000 and \$31,000 for the years ended December 31, 2013 and 2012. Charge offs resulting from the above defaults were \$155,000 and \$66,000 respectively. The total allowance for loan and lease losses specifically allocated to the balances that were classified as TDRs during the year ended December 31, 2013 and 2012 is \$3,321,000 and \$1,079,000, respectively.

**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**4. LOANS AND LEASES (Continued)**

Interest income for all performing loans, regardless of class (Pass, Special Mention, Substandard and Impaired), is recognized on an accrual basis, with interest accrued daily. Costs associated with successful loan originations are netted from loan origination fees, with the net amount (net deferred loan fees) amortized over the contractual life of the loan in interest income. If a loan has scheduled periodic payments, the amortization of the net deferred loan fee is calculated using the effective interest method over the contractual life of the loan. If the loan does not have scheduled payments, such as a line of credit, the net deferred loan fee is recognized as interest income on a straight line basis over the contractual life of the loan. Fees received for loan commitments are recognized as interest income over the term of the commitment. When loans are repaid, any remaining unamortized balances of deferred fees and costs are accounted for through interest income.

Loan Servicing

The Company originates mortgage loans for sale to investors. During the years ended December 31, 2013, 2012, and 2011, all mortgage loans that were sold by the Company were sold without retention of related servicing. The Company's servicing portfolio at December 31, 2013, 2012 and 2011 totaled \$1,585,000, \$2,596,000 and \$506,000, respectively. At December 31, 2013, loans were principally serviced for one investor.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**5. PREMISES AND EQUIPMENT**

Premises and equipment at cost consisted of the following (dollars in thousands):

|  | December 31, |          |
|--|--------------|----------|
|  | 2013         | 2012     |
| Land   | \$2,607      | \$2,607  |
| Buildings and improvements                     | 15,818       | 15,720   |
| Furniture, fixtures and equipment              | 17,829       | 20,476   |
| Leasehold improvements                         | 10,536       | 10,496   |
|  | 46,790       | 49,299   |
| Less accumulated depreciation and amortization | 26,402       | 27,473   |
| Construction in progress                       | 5            | 4        |
|  | \$20,393     | \$21,830 |

Depreciation and amortization included in occupancy and equipment expense totaled \$2,119,000, \$2,289,000, and \$2,505,000, for the years ended December 31, 2013, 2012 and 2011, respectively.

**6. OTHER ASSETS**

Other assets consisted of the following (dollars in thousands):

|                             | December 31, |         |
|-----------------------------|--------------|---------|
|                             | 2013         | 2012    |
| Accrued interest receivable | \$4,990      | \$5,095 |
| Deferred tax assets         | 12,286       | 11,995  |

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|   |          |          |
|---|----------|----------|
| Prepaid taxes   | 2,787    | 3,775    |
| Investment in limited partnerships                      | 9,204    | 10,316   |
| Federal Home Loan Bank stock, at cost                   | 5,581    | 6,019    |
| Cash surrender value of officer life insurance policies | 39,424   | 38,007   |
| Other   | 5,613    | 6,262    |
|   | \$79,885 | \$81,469 |

The Company has invested in limited partnerships that operate qualified affordable housing projects to receive tax benefits in the form of tax deductions from operating losses and tax credits. The Company accounts for these investments under the cost method and management analyzes these investments annually for potential impairment. The Company has no remaining capital commitments to these partnerships at December 31, 2013.

The Company holds certain equity investments that are not readily marketable securities and thus are classified as “other assets” on the Company’s balance sheet. These include investments in Pacific Coast Bankers Bancshares, California Economic Development Lending Initiative, and the Federal Home Loan Bank (“FHLB”).

The largest of these is the Company’s \$5,581,000 investment in FHLB stock, carried at cost. Quarterly, the FHLB evaluates and adjusts the Company’s minimum stock requirement based on the Company’s borrowing activity and membership requirements. Any stock deemed in excess is automatically repurchased by the FHLB at cost.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**7.DEPOSITS**

Interest-bearing deposits consisted of the following (dollars in thousands):

|                                  | December 31, |           |
|----------------------------------|--------------|-----------|
|                                  | 2013         | 2012      |
| Interest Bearing Demand Deposits | \$82,408     | \$84,655  |
| NOW                              | 200,313      | 196,771   |
| Savings                          | 144,162      | 118,547   |
| Money Market                     | 73,132       | 71,222    |
| CDAR's, Under \$100,000          | 437          | 791       |
| CDAR's, \$100,000 or more        | 12,919       | 14,274    |
| Time, Under \$100,000            | 79,261       | 101,893   |
| Time, \$100,000 or more          | 205,550      | 218,284   |
| Brokered Deposits                | 10,000       | 15,000    |
|                                  | \$808,182    | \$821,437 |

Aggregate annual maturities of time deposits are as follows (dollars in thousands):

| Year Ending December 31, |           |
|--------------------------|-----------|
| 2014                     | \$296,969 |
| 2015                     | 8,467     |
| 2016                     | 989       |
| 2017                     | 833       |
| 2018                     | 290       |
| Thereafter               | 619       |
|                          | \$308,167 |



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Interest expense recognized on interest-bearing deposits consisted of the following (dollars in thousands):

|                                  | Year Ended December 31, |          |          |
|----------------------------------|-------------------------|----------|----------|
|                                  | 2013                    | 2012     | 2011     |
| Interest Bearing Demand Deposits | \$ 281                  | \$ 257   | \$ 137   |
| NOW                              | 359                     | 556      | 860      |
| Savings                          | 285                     | 241      | 203      |
| Money Market                     | 94                      | 127      | 506      |
| CDAR's, Under \$100,000          | -                       | 2        | 5        |
| CDAR's, \$100,000 or more        | 36                      | 50       | 194      |
| Time, Under \$100,000            | 420                     | 619      | 1,001    |
| Time, \$100,000 or more          | 823                     | 1,154    | 1,223    |
| Brokered Deposits                | 157                     | 202      | 176      |
|                                  | \$ 2,455                | \$ 3,208 | \$ 4,305 |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**8. OTHER BORROWING ARRANGEMENTS**

Short-term borrowings consisted of the following (dollars in thousands):

|                                 | 2013    |            | 2012     |            |   |
|---------------------------------|---------|------------|----------|------------|---|
|                                 | Amount  | Fixed Rate | Amount   | Fixed Rate |   |
| As of December 31:              |         |            |          |            |   |
| Repurchase agreements           | \$5,974 | .44        | %\$1,419 | .60        | % |
| Overnight Federal Home Loan     |         |            |          |            |   |
| Bank advances                   | -       | -          | 36,650   | .26        | % |
| Federal Home Loan Bank advances | -       | -          | -        | -          |   |
|                                 | \$5,974 |            | \$38,069 |            |   |

The Company had unsecured lines of credit with its correspondent banks which, in the aggregate, amounted to \$70,000,000 and \$55,000,000 at December 31, 2013 and 2012, respectively, at interest rates which vary with market conditions. There was \$0 outstanding under these lines of credit at December 31, 2013 and December 31, 2012, respectively.

At December 31, 2013, the Company had remaining borrowing capacity with the Federal Home Loan Bank of \$93,380,000 secured by government agencies and whole loan collateral.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**9. INCOME TAXES**

The provision for income taxes follows (dollars in thousands):

|          | Year Ended December 31, |          |        |
|----------|-------------------------|----------|--------|
|          | 2013                    | 2012     | 2011   |
| Federal: |                         |          |        |
| Current  | \$ 563                  | \$ 220   | \$ 627 |
| Deferred | 1,842                   | (647)    | (706)  |
|          | 2,405                   | (427)    | (79)   |
| State:   |                         |          |        |
| Current  | 170                     | -        | 818    |
| Deferred | 518                     | 83       | (175)  |
|          | 688                     | 83       | 643    |
|          | \$ 3,093                | \$ (344) | \$ 564 |

The components of the net deferred tax asset, included in other assets, are as follows (dollars in thousands):

|  | December 31, |         |
|--|--------------|---------|
|  | 2013         | 2012    |
| Deferred tax assets:                   |              |         |
| Allowance for loan losses              | \$5,669      | \$6,594 |
| Foreclosed Assets                      | 1,779        | 4,461   |
| Deferred compensation                  | 4,112        | 3,627   |
| Accrued reserves                       | 594          | 502     |
| Non Accrual Loans                      | 1,211        | 865     |
| Other than temporary impairment charge | 576          | 576     |
| Credit Carryforward                    | 3,089        | 2,273   |
| Other                                  | 153          | 185     |
| Total deferred tax assets              | 17,183       | 19,083  |

|  |          |          |
|--|----------|----------|
| Deferred tax liabilities:                        |          |          |
| Premises and equipment                           | (589)    | (552)    |
| Deferred loan costs                              | (2,254)  | (2,152)  |
| Unrealized gain on securities available-for-sale | (299)    | (2,602)  |
| Other  | (1,755)  | (1,782)  |
| Total deferred tax liabilities                   | (4,897)  | (7,088)  |
| Net deferred tax assets                          | \$12,286 | \$11,995 |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**9. INCOME TAXES (Continued)**

The expense for income taxes differs from amounts computed by applying the statutory Federal income tax rates to income before income taxes. The significant items comprising these differences consisted of the following (dollars in thousands):

|  | Year Ended December 31, |         |         |
|--|-------------------------|---------|---------|
|  | 2013                    | 2012    | 2011    |
| Income tax expense at Federal statutory rate           | \$5,597                 | \$2,666 | \$2,837 |
| Increase (decrease) resulting from:                    |                         |         |         |
| State franchise tax expense, net of Federal tax effect | 414                     | -       | 540     |
| Tax exempt income                                      | (920)                   | (1,388) | (1,330) |
| Affordable housing tax credits                         | (1,257)                 | (1,639) | (1,605) |
| Other  | (741)                   | 17      | 122     |
|  | \$3,093                 | \$(344) | \$564   |
| Effective tax rate                                     | 18.8 %                  | (4.4) % | 6.8 %   |

The Company is subject to federal income tax and income tax of the state of California. Our federal income tax returns for the years ended December 31, 2010, 2011 and 2012 are open to audit by the federal authorities and our California state tax returns for the years ended December 31, 2009, 2010, 2011 and 2012 are open to audit by the state authorities.

There were no recorded interest or penalties related to uncertain tax positions as part of income tax for the years ended December 31, 2013, 2012, and 2011, respectively. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next twelve months.

**10. SUBORDINATED DEBENTURES**

Sierra Statutory Trust II (“Trust II”) and Sierra Capital Trust III (“Trust III”), (collectively, the “Trusts”) were formed by the Company for the sole purpose of issuing trust preferred securities fully and unconditionally guaranteed by the Company. For financial reporting purposes, the Trusts are not consolidated and the Floating Rate Junior Subordinated Deferrable Interest Debentures (the “Subordinated Debentures”) held by the Trusts and issued and guaranteed by the Company are reflected in the Company’s consolidated balance sheet in accordance with provisions of ASC Topic 810. Under applicable regulatory guidance, the amount of trust preferred securities that is eligible as Tier 1 capital is limited to twenty-five percent of the Company’s Tier 1 capital on a pro forma basis. At December 31, 2013, \$30,000,000 of the Company’s trust preferred securities qualified as Tier 1 capital.

During the first quarter of 2004, Sierra Statutory Trust II issued 15,000 Floating Rate Capital Trust Pass-Through Securities (TRUPS II), with a liquidation value of \$1,000 per security, for gross proceeds of \$15,000,000. The entire proceeds of the issuance were invested by Trust II in \$15,464,000 of Subordinated Debentures issued by the Company, with identical maturity, re-pricing and payment terms as the TRUPS II. The Subordinated Debentures, purchased by Trust II, represent the sole assets of the Trust II. Those Subordinated Debentures mature on March 17, 2034, bear a current interest rate of 2.99% (based on 3-month LIBOR plus 2.75%), with re-pricing and payments due quarterly.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 10. SUBORDINATED DEBENTURES (Continued)

Those Subordinated Debentures are currently redeemable by the Company, subject to receipt by the Company of prior approval from the Federal Reserve Bank, on any March 17<sup>th</sup>, June 17<sup>th</sup>, September 17<sup>th</sup>, or December 17<sup>th</sup>. The redemption price is par plus accrued and unpaid interest, except in the case of redemption under a special event which is defined in the debenture.

The TRUPS II are subject to mandatory redemption to the extent of any early redemption of the related Subordinated Debentures and upon maturity of the Subordinated Debentures on March 17, 2034.

Trust II has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default on the payment of interest on the Subordinated Debentures. The TRUPS II issued in the offering were sold in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the TRUPS II.

During the second quarter of 2006, Sierra Capital Trust III issued 15,000 Floating Rate Capital Trust Pass-Through Securities (TRUPS III), with a liquidation value of \$1,000 per security, for gross proceeds of \$15,000,000. The entire proceeds of the issuance were invested by Trust III in \$15,464,000 of Subordinated Debentures issued by the Company, with identical maturity, repricing and payment terms as the TRUPS III. The Subordinated Debentures, purchased by Trust III, represent the sole assets of the Trust III. Those Subordinated Debentures mature on September 23, 2036, bear a current interest rate of 1.65% (based on 3-month LIBOR plus 1.40%), with repricing and payments due quarterly.

Those Subordinated Debentures are redeemable by the Company, subject to receipt by the Company of prior approval from the Federal Reserve Bank, on any March 23<sup>rd</sup>, June 23<sup>rd</sup>, September 23<sup>rd</sup>, or December 23<sup>rd</sup>. The redemption price is par plus accrued and unpaid interest, except in the case of redemption under a special event which is defined in the debenture. The TRUPS III are subject to mandatory redemption to the extent of any early redemption of the related Subordinated Debentures and upon maturity of the Subordinated Debentures on September 23, 2036.

Trust III has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default on the payment of interest on the Subordinated Debentures. The TRUPS III issued in the offering were sold in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the TRUPS III.



**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**11. COMMITMENTS AND CONTINGENCIES**

Leases

The Company leases certain of its branch facilities under non-cancelable operating leases. Rental expense included in occupancy and equipment expense totaled \$1,001,000, \$1,011,000 and \$1,167,000 and for the years ended December 31, 2013, 2012 and 2011, respectively.

Future minimum lease payments on non-cancelable operating leases are as follows:

| Year Ending<br>December 31, |              |
|-----------------------------|--------------|
| 2014                        | \$ 1,036,000 |
| 2015                        | 996,000      |
| 2016                        | 792,000      |
| 2017                        | 783,000      |
| 2018                        | 669,000      |
| Thereafter                  | 4,339,000    |
|                             | \$8,615,000  |

The Company has options to renew its branch facilities after the initial leases expire. The renewal options range from one to ten years and are not included in the payments reflected above.

Letter of Credit

The Company holds two letters of credit with the Federal Home Loan Bank of San Francisco totaling \$78,000,000. A \$70,000,000 letter of credit is pledged to secure public deposits at December 31, 2013 and an \$8,000,000 standby letter of credit was obtained on behalf of one of our customers to guarantee financial performance. Should the standby letter of credit be drawn upon, the customer would reimburse the Company from an existing line of credit.

#### Federal Reserve Requirements

Banks are required to maintain reserves with the Federal Reserve Bank equal to a specified percentage of their reservable deposits less vault cash. The reserve balances maintained at the Federal Reserve Bank at December 31, 2013 and 2012 were \$41,761,000 and \$38,962,000, respectively.

#### Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and letters of credit as it does for loans included on the balance sheet.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**11. COMMITMENTS AND CONTINGENCIES (Continued)**

The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

|  | Years Ended December 31, |            |
|--|--------------------------|------------|
|  | 2013                     | 2012       |
| Fixed-rate commitments to extend credit    | \$ 64,148                | \$ 53,550  |
| Variable-rate commitments to extend credit | \$ 356,559               | \$ 171,850 |
| Standby letters of credit                  | \$ 8,703                 | \$ 6,690   |
| Commercial and similar letters of credit   | \$ 8,070                 | \$ 8,539   |

Commitments to extend credit consist primarily of the unused or unfunded portions of the following: home equity lines of credit; commercial real estate construction loans, where disbursements are made over the course of construction; commercial revolving lines of credit; mortgage warehouse lines of credit; unsecured personal lines of credit; and formalized (disclosed) deposit account overdraft lines. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to extend credit are made at both fixed and variable rates of interest as stated in the table above. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company's commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

**Concentration in Real Estate Lending**

At December 31, 2013, in management's judgment, a concentration of loans existed in real estate related loans. At that date, approximately 72% of the Company's loans were real estate related. Balances secured by commercial buildings and construction and development loans represented 55% of all real estate loans, while loans secured by non-construction residential properties accounted for 26%, and loans secured by farmland were 19% of real estate loans. Although management believes the loans within these concentrations have no more than the normal risk of

collectability, a further decline in the performance of the economy in general or a further decline in real estate values in the Company's primary market areas, in particular, could have an adverse impact on collectability.

#### Concentration by Geographic Location

The Company grants commercial, real estate mortgage, real estate construction and consumer loans to customers primarily in the South Central San Joaquin Valley of California, specifically Tulare, Fresno, Kern, Kings and Madera counties. The ability of a substantial portion of the Company's customers to honor their contracts is dependent on the economy in these areas. Although the Company's loan portfolio is diversified, there is a relationship in this region between the local agricultural economy and the economic performance of loans made to non-agricultural customers.

#### Contingencies

The Company is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the consolidated financial position or results of operations of the Company.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**12.SHAREHOLDERS' EQUITY**Share Repurchase Plan

At December 31, 2013, the Company had a stock repurchase plan which has no expiration date. During the year ended December 31, 2013, the Company did not repurchase any shares. The total number of shares available for repurchase at December 31, 2013 was 700,000. Repurchases are generally made in the open market at market prices.

Earnings Per Share

A reconciliation of the numerators and denominators of the basic and diluted earnings per share computations is as follows:

|                                     | For the Years Ended December 31, |            |            |
|-------------------------------------|----------------------------------|------------|------------|
|                                     | 2013                             | 2012       | 2011       |
| <b>Basic Earnings Per Share</b>     |                                  |            |            |
| Net income (dollars in thousands)   | \$13,369                         | \$8,185    | \$7,780    |
| Weighted average shares outstanding | 14,155,927                       | 14,103,805 | 14,036,667 |
| Basic earnings per share            | \$0.94                           | \$0.58     | \$0.55     |
| <b>Diluted Earnings Per Share</b>   |                                  |            |            |
| Net income (dollars in thousands)   | \$13,369                         | \$8,185    | \$7,780    |
| Weighted average shares outstanding | 14,155,927                       | 14,103,805 | 14,036,667 |

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|                                     |            |            |            |
|-------------------------------------|------------|------------|------------|
| Effect of dilutive stock options    | 134,223    | 16,508     | 48,534     |
| Weighted average shares outstanding | 14,290,150 | 14,120,313 | 14,085,201 |
| Diluted earnings per share          | \$0.94     | \$0.58     | \$0.55     |

Stock Options

In June 1998, Bank of the Sierra adopted the 1998 Stock Option Plan (the “1998 Plan”) for which shares were reserved for issuance to employees and directors under incentive and non-statutory agreements. The 1998 Plan was assumed by the Company effective August 10, 2001. Effective May 23, 2007, the 1998 Plan was terminated and no further options may be granted thereunder, but options granted under the 1998 Plan which were outstanding as of the termination date were not affected by this termination. As of December 31, 2013, options granted under the 1998 Plan covering 143,550 shares were still outstanding.

On March 15, 2007 the Board of Directors approved and adopted the Company’s 2007 Stock Incentive Plan (the “2007 Plan”), which was approved by the Company’s shareholders on May 23, 2007. The 2007 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of “nonqualified” stock options to non-employee directors, of the Company and its subsidiaries. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, which awards may be granted on such terms and conditions as are established by the Board of Directors or the Compensation Committee in its discretion. We have not issued, nor do we currently have plans to issue, restricted stock awards.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**12.SHAREHOLDERS' EQUITY (Continued)**

The maximum number of shares subject to issuance under the 2007 Plan was originally 1,500,000 shares of the Company's authorized but unissued common stock, covering both restricted stock awards and stock options. The number subject to issuance under the 2007 Plan had declined to 780,920 at December 31, 2013, due to stock options already granted under the plan net of any canceled options that were returned to the pool available for issuance.

All options granted under the 2007 Plan have been or will be granted at an exercise price of not less than 100% of the fair market value of the stock on the date of grant, exercisable in installments as provided in individual stock option agreements. In the event of a "Change in Control" as defined in the 2007 Plan, all outstanding options shall become exercisable in full (subject to certain notification requirements), and shall terminate if not exercised within a specified period of time unless such options are assumed by the successor corporation or substitute options are granted. Options also terminate in the event an optionee ceases to be employed by or to serve as a director of the Company or its subsidiaries, and the vested portion thereof must be exercised within 30 days after such cessation of employment or service.

A summary of the Company's stock option activity, including options from the 1998 Plan, follows (shares in thousands, except exercise price):

|                                | 2013   |  |  | 2012   |  | 2011   |  |
|--------------------------------|--------|--|--|--------|--|--------|--|
|                                | Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value <sup>(1)</sup> | Shares | Weighted<br>Average<br>Exercise<br>Price | Shares | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding, beginning of year | 927    | \$ 14.16                                 |  | 810    | \$ 14.97                                 | 835    | \$ 14.24                                 |
| Exercised                      | (111)  | \$ 9.87                                  |  | (5)    | \$ 9.45                                  | (125)  | \$ 6.72                                  |
| Granted                        | -      | \$ -                                     |  | 189    | \$ 10.21                                 | 186    | \$ 10.58                                 |
| Canceled                       | (70)   | \$ 15.75                                 |  | (67)   | \$ 13.08                                 | (86)   | \$ 10.43                                 |
| Outstanding, end of year       | 746    | \$ 14.65                                 | \$ 2,961                                       | 927    | \$ 14.16                                 | 810    | \$ 14.97                                 |

|   |     |          |        |     |          |     |          |
|---|-----|----------|--------|-----|----------|-----|----------|
| Exercisable, end of year <sup>(2)</sup> | 542 | \$ 16.30 | \$ 583 | 599 | \$ 16.07 | 504 | \$ 17.15 |
|---|-----|----------|--------|-----|----------|-----|----------|

<sup>(1)</sup>The aggregate intrinsic value of stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2013. This amount changes based on changes in the market value of the Company's stock.

<sup>(2)</sup>The weighted average remaining contractual life of stock options outstanding and exercisable on December 31, 2013 was 6.0 years and 7.1 years, respectively.

Information related to stock options during each year follows:

|  | 2013      | 2012      | 2011      |
|--|-----------|-----------|-----------|
| Weighted-average grant-date fair value per share | \$-       | \$3.86    | \$3.79    |
| Total intrinsic value of stock options exercised | \$605,000 | \$9,000   | \$465,000 |
| Total fair value of stock options vested         | \$583,000 | \$517,000 | \$-       |

Cash received from the exercise of 110,240 shares was \$1,088,000 for the period ended December 31, 2013 with a related tax benefit of \$147,000.



## **SIERRA BANCORP AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

#### **12. SHAREHOLDERS' EQUITY (Continued)**

The Company is using the Black-Scholes model to value stock options. In accordance with U.S. GAAP, charges of \$268,000, \$487,000 and \$460,000 are reflected in the Company's income statements for the years ended December 31, 2013, 2012 and 2011, respectively, as pre-tax compensation and directors' expense related to stock options. The related tax benefit of these options is \$110,000, \$200,000 and \$189,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

Unamortized compensation expense associated with unvested stock options outstanding at December 31, 2013 was \$280,000, which will be recognized over the next 3.8 years.

#### **13. REGULATORY MATTERS**

The Company and the Bank are subject to certain regulatory requirements administered by the Board of Governors of the Federal Reserve System and the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Each of these components is defined in the regulations. Management believes that the Company and the Bank met all of their capital adequacy requirements as of December 31, 2013 and 2012. In addition, as of December 31, 2013 and 2012, notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and leverage capital ratios as set forth below (dollars in

thousands):

|   | Years Ended December 31, |         |            |         |
|---|--------------------------|---------|------------|---------|
|   | 2013                     |         | 2012       |         |
|   | Capital                  | Ratio   | Capital    | Ratio   |
|   | Amount                   |         | Amount     |         |
| Leverage Ratio  |                          |         |            |         |
| Sierra Bancorp and subsidiary                           | \$ 198,216               | 14.37 % | \$ 186,783 | 13.34 % |
| Minimum requirement for "Well-Capitalized" institutions | 68,969                   | 5.0 %   | 69,993     | 5.0 %   |
| Minimum regulatory requirement                          | 55,175                   | 4.0 %   | 55,994     | 4.0 %   |
| Bank of the Sierra                                      | \$ 195,001               | 14.18 % | \$ 184,024 | 13.17 % |
| Minimum requirement for "Well-Capitalized" institutions | 68,765                   | 5.0 %   | 69,866     | 5.0 %   |
| Minimum regulatory requirement                          | 55,012                   | 4.0 %   | 55,893     | 4.0 %   |

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**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**13. REGULATORY MATTERS (Continued)**

|   | Years Ended December 31, |         |           |         |
|---|--------------------------|---------|-----------|---------|
|   | 2013                     |         | 2012      |         |
|   | Capital                  | Ratio   | Capital   | Ratio   |
|   | Amount                   |         | Amount    |         |
| Tier 1 Risk-Based Capital Ratio                         |                          |         |           |         |
| Sierra Bancorp and subsidiary                           | \$198,225                | 20.39 % | \$183,783 | 18.11 % |
| Minimum requirement for "Well-Capitalized" institutions | 58,330                   | 6.0 %   | 61,878    | 6.0 %   |
| Minimum regulatory requirement                          | 38,887                   | 4.0 %   | 41,252    | 4.0 %   |
| Bank of the Sierra                                      | \$195,001                | 20.11 % | \$184,024 | 17.88 % |
| Minimum requirement for "Well-Capitalized" institutions | 58,174                   | 6.0 %   | 61,737    | 6.0 %   |
| Minimum regulatory requirement                          | 38,783                   | 4.0 %   | 41,158    | 4.0 %   |
| Total Risk-Based Capital Ratio                          |                          |         |           |         |
| Sierra Bancorp and subsidiary                           | \$210,669                | 21.67 % | \$199,700 | 19.36 % |
| Minimum requirement for "Well-Capitalized" institutions | 97,217                   | 10.0 %  | 103,131   | 10.0 %  |
| Minimum regulatory requirement                          | 77,773                   | 8.0 %   | 82,504    | 8.0 %   |
| Bank of the Sierra                                      | \$206,960                | 21.35 % | \$196,912 | 19.14 % |
| Minimum requirement for "Well-Capitalized" institutions | 96,957                   | 10.0 %  | 102,895   | 10.0 %  |
| Minimum regulatory requirement                          | 77,565                   | 8.0 %   | 82,316    | 8.0 %   |

Under current rules of the Federal Reserve Board, qualified trust preferred securities are one of several "restricted" core capital elements which may be included in Tier 1 capital in an aggregate amount limited to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. Since the Company had less than \$15 billion in assets at December 31, 2013, under the Dodd-Frank Act the Company will be able to continue to include its existing trust preferred securities in Tier 1 Capital to the extent permitted by FRB guidelines.

Dividend Restrictions

The Company's ability to pay cash dividends is dependent on dividends paid to it by the Bank, and is also limited by state corporation law. The California General Corporation Law allows a California corporation to pay dividends if the Company's retained earnings equal at least the amount of the proposed dividend. If the Company does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if immediately after giving effect to the dividend the sum of the company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities.

Dividends from the Bank to the Company are restricted under California law to the lesser of the Bank's retained earnings or the Bank's net income for the latest three fiscal years, less dividends previously declared during that period, or, with the approval of the Department of Business Oversight, to the greater of the retained earnings of the Bank, the net income of the Bank for its last fiscal year, or the net income of the Bank for its current fiscal year. As of December 31, 2013, the maximum amount available for dividend distribution under this restriction was approximately \$29,854,000.

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 14. BENEFIT PLANS

##### Salary Continuation Agreements, Directors' Retirement and Officer Supplemental Life Insurance Plans

The Company has entered into salary continuation agreements with its executive officers, and has established retirement plans for qualifying members of the Board of Directors. The plans provide for annual benefits for up to fifteen years after retirement or death. The benefit obligation under these plans totaled \$4,952,000 and \$4,747,000 and was fully accrued for the years ended December 31, 2013 and 2012, respectively. The expense recognized under these arrangements totaled \$288,000 and \$292,000, and \$403,000 for the years ended December 31, 2013, 2012 and 2011, respectively. Salary continuation benefits paid to former directors or executives of the Company or their beneficiaries totaled \$83,000 for each of the years ended December 31, 2013, 2012 and 2011. The Company also provides benefits to former executives of Sierra National Bank under salary continuation plans that were in effect at the time Sierra National Bank was merged into Bank of the Sierra. The benefit obligation under these plans totaled \$89,000, \$145,000 and \$197,000, and was fully accrued for the years ended December 31, 2013, 2012, and 2011, respectively. Benefits paid to former executives of SNB under this plan totaled \$67,000, for each of the years ended December 31, 2013, 2012, and 2011, respectively. Certain officers of the Company have supplemental life insurance policies with death benefits available to the officers' beneficiaries.

In connection with these plans the Company has purchased, or acquired through the merger, single premium life insurance policies with cash surrender values totaling \$35,250,000 and \$34,762,000 at December 31, 2013 and 2012, respectively. On the consolidated balance sheet, the cash surrender values are included in other assets.

##### Officer and Director Deferred Compensation Plan

The Company has established a deferred compensation plan for certain members of the management group and a deferred fee plan for directors for the purpose of providing the opportunity for participants to defer compensation. The Company bears the costs for the plan's administration and the interest earned on participant deferrals. The related administrative expense was not material for the years ended December 31, 2013, 2012 and 2011. In connection with this plan, life insurance policies with cash surrender values totaling \$4,174,000 and \$3,245,000 at December 31, 2013

and 2012, respectively, are included on the consolidated balance sheet in other assets.

#### 401(k) Savings Plan

The 401(k) savings plan (the "Plan") allows participants to defer, on a pre-tax basis, up to 15% of their salary (subject to Internal Revenue Service limitations) and accumulate tax-deferred earnings as a retirement fund. The Bank may make a discretionary contribution to match a specified percentage of the first 6% of the participants' contributions annually. The amount of the matching contribution was 60% for the year ended December 31, 2013 and 50% for each of the years ended December 31, 2012 and 2011. The matching contribution is discretionary, vests over a period of five years from the participants' hire date, and is subject to the approval of the Board of Directors. The Company contributed \$360,000, \$302,000 and \$304,000 to the Plan in 2013, 2012 and 2011, respectively.

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**15. NON-INTEREST REVENUE**

The major grouping of non-interest revenue on the consolidated income statements includes several specific items: service charges on deposit accounts, gains on the sale of loans, credit card fees, check card fees, the net gain (loss) on sales and calls of investment securities available for sale, and the net increase (decrease) in the cash surrender value of life insurance.

Non-interest revenue also includes one general category of “other income” of which the following are major components (dollars in thousands):

|                                  | Year Ended December 31, |          |          |
|----------------------------------|-------------------------|----------|----------|
|                                  | 2013                    | 2012     | 2011     |
| Included in other income:        |                         |          |          |
| Loss on limited partnerships     | \$(1,063)               | \$(395)  | \$(885)  |
| Dividends on Equity Investments  | 356                     | 67       | 26       |
| Rental income on leases          | 46                      | 102      | 173      |
| Other                            | 2,569                   | 2,134    | 1,842    |
| Total other non-interest revenue | \$ 1,908                | \$ 1,908 | \$ 1,156 |

**16. OTHER OPERATING EXPENSE**

Other expense consisted of the following (dollars in thousands):

|                   | Year Ended December 31, |         |         |
|-------------------|-------------------------|---------|---------|
|                   | 2013                    | 2012    | 2011    |
| Professional fees | \$4,143                 | \$3,454 | \$3,941 |
| Data processing   | 1,987                   | 1,807   | 1,523   |

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|                                  |          |          |          |
|----------------------------------|----------|----------|----------|
| Advertising and promotion        | 1,960    | 1,771    | 2,051    |
| Deposit services                 | 1,980    | 2,266    | 2,516    |
| Stationery and supplies          | 657      | 738      | 705      |
| Telephone and data communication | 1,613    | 1,549    | 1,291    |
| Loan and credit card processing  | 1,327    | 419      | 1,082    |
| Foreclosed assets expense        | 1,202    | 4,914    | 5,226    |
| Postage                          | 713      | 718      | 576      |
| Other                            | 1,039    | 1,905    | 1,267    |
| <br>                             |          |          |          |
| Total other non-interest expense | \$16,621 | \$19,541 | \$20,178 |



**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**17. RELATED PARTY TRANSACTIONS**

During the normal course of business, the Bank enters into loans with related parties, including executive officers and directors. These loans are made with substantially the same terms, including rates and collateral, as loans to unrelated parties. The following is a summary of the aggregate activity involving related party borrowers (dollars in thousands):

|  | Year Ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2013                    | 2012     | 2011     |
| Balance, beginning of year                 | \$ 629                  | \$ 2,471 | \$ 3,465 |
| Disbursements                              | 543                     | 625      | 773      |
| Amounts repaid                             | (606)                   | (2,467)  | (1,767)  |
| Decreased                                  | -                       | -        | -        |
| Balance, end of year                       | \$ 566                  | \$ 629   | \$ 2,471 |
| Undisbursed commitments to related parties | \$ 460                  | \$ 330   | \$ 472   |

Deposits from related parties held by the Bank at December 31, 2013 and 2012 amounted to \$7,523,000 and \$9,012,000, respectively.

**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**18. FAIR VALUE**

Fair value is defined by U.S. GAAP as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

§ Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

§ Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

§ Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would use in pricing an asset or liability.

**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**18. FAIR VALUE (Continued)**

The Company used the following methods and significant assumptions to estimate fair values for each category of financial asset noted below:

Securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.

Collateral-dependent impaired loans: A specific loss allowance is created for collateral dependent impaired loans, representing the difference between the face value of the loan and its current appraised value less estimated disposition costs.

Foreclosed assets: Repossessed real estate (OREO) and other assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes, and for all other assets fair value is represented by the estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 18. FAIR VALUE (Continued)

Assets and liabilities measured at fair value on a recurring basis, including financial liabilities for which the Company has elected the fair value option, are summarized below (dollars in thousands):

|                                     | Fair Value Measurements at December 31, 2013, Using                        |  |  |            |                         |
|-------------------------------------|--|--|--|------------|-------------------------|
|                                     | Quoted Prices in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      | Realized<br>Gain/(Loss) |
| Investment Securities               |  |  |  |            |                         |
| US Government Agencies              | \$ -   | \$ 5,304   | \$ -   | \$ 5,304   | \$ -                    |
| Mortgage-backed securities          | -  | 320,721  | -  | 320,721    | -                       |
| State and political subdivisions    | -  | 96,563   | -  | 96,563     | -                       |
| Equity securities                   | 2,456  | -  | -  | 2,456      | -                       |
| Total available-for-sale securities | \$ 2,456   | \$ 422,588                                       | \$ -   | \$ 425,044 | \$ -                    |

|                                     | Fair Value Measurements at December 31, 2012, Using                        |  |  |            |                         |
|-------------------------------------|--|--|--|------------|-------------------------|
|                                     | Quoted Prices in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      | Realized<br>Gain/(Loss) |
| Investment Securities               |  |  |  |            |                         |
| US Government Agencies              | \$ -   | \$ 2,973   | \$ -   | \$ 2,973   | \$ -                    |
| Mortgage-backed securities          | -  | 301,389  | -  | 301,389    | -                       |
| State and political subdivisions    | -  | 73,986   | -  | 73,986     | -                       |
| Equity securities                   | 1,809  | 31   | -  | 1,840      | -                       |
| Total available-for-sale securities | \$ 1,809   | \$ 378,379                                       | \$ -   | \$ 380,188 | \$ -                    |



**SIERRA BANCORP AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**18. FAIR VALUE (Continued)**

Assets and liabilities measured at fair market value on a non-recurring basis are summarized below (dollars in thousands):

|                                     | Year Ended December 31, 2013 |             |              |           |
|-------------------------------------|------------------------------|-------------|--------------|-----------|
|                                     | Quoted Significant           | Significant | Significant  |           |
|                                     | Observable                   | Observable  | Unobservable |           |
|                                     | Identifiable                 | Assets      | Inputs       | Total     |
|                                     | (Level 1)                    | (Level 2)   | (Level 3)    |           |
| Collateral Dependent Impaired Loans | \$ -                         | \$ 14,705   | \$ -         | \$ 14,705 |
| Foreclosed Assets                   | \$ -                         | \$ 8,185    | \$ -         | \$ 8,185  |

|                                     | Year Ended December 31, 2012 |             |              |           |
|-------------------------------------|------------------------------|-------------|--------------|-----------|
|                                     | Quoted Significant           | Significant | Significant  |           |
|                                     | Observable                   | Observable  | Unobservable |           |
|                                     | Identifiable                 | Assets      | Inputs       | Total     |
|                                     | (Level 1)                    | (Level 2)   | (Level 3)    |           |
| Collateral Dependent Impaired Loans | \$ -                         | \$ 27,449   | \$ -         | \$ 27,449 |
| Foreclosed Assets                   | \$ -                         | \$ 19,754   | \$ -         | \$ 19,754 |

## SIERRA BANCORP AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Disclosures include estimated fair values for financial instruments for which it is practicable to estimate fair value. These estimates are made at a specific point in time based on relevant market data and information about the financial instruments. 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.

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. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments at December 31, 2013 and 2012:

Cash and cash equivalents, and fed funds sold: For cash and cash equivalents and fed funds sold, the carrying amount is estimated to be fair value.

Investment securities: The fair values of investment securities are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.

Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms, to borrowers of comparable creditworthiness.

Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available-for-sale loans stay on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

Cash surrender value of life insurance policies: The fair values are based on current cash surrender values at each reporting date provided by the insurers.

Investment in limited partnerships: The fair values of our investments in limited partnerships are estimated using quarterly indications of value provided by the general partner. The fair values of undisbursed capital commitments are assumed to be the same as their book values.

Other investments: Included in other assets are certain long-term investments carried at cost, which approximates estimated fair value, unless an impairment analysis indicates the need for adjustments.

Deposits: Fair values for non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities.

Short-term borrowings: The carrying amounts approximate fair values for federal funds purchased, overnight FHLB advances, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company's current incremental borrowing rates for similar types of borrowing arrangements.



**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

Long-term borrowings: The fair values of the Company's long-term borrowings are estimated using projected cash flows discounted at the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Subordinated debentures: The fair values of subordinated debentures are determined based on the current market value for like instruments of a similar maturity and structure.

Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would approximate fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

Carrying amount and estimated fair values of financial instruments were as follows (dollars in thousands):

|  | Year Ended December 31, 2013 |   |  |  | Total    |
|--|------------------------------|---|--|--|----------|
|  | Carrying Amount              | Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1) | Estimated Fair Value Significant Unobservable Inputs (Level 2) | Estimated Fair Value Significant Unobservable Inputs (Level 3) |          |
| Financial Assets:                        |                              |   |  |  |          |
| Cash and cash equivalents                | \$78,006                     | \$78,006  | \$ -   | \$ -   | \$78,006 |
| Investment securities available for sale | 425,044                      | 2,456   | 422,588  | -  | 425,044  |
| Loans and leases held for investment     | 778,382                      | -   | 797,383  | -  | 797,383  |
| Collateral dependent impaired loans      | 14,705                       | -   | 14,705   | -  | 14,705   |
| Loans held-for-sale                      | 105                          | 105   | -  | -  | 105      |
|  | 39,424                       | -   | 39,424   | -  | 39,424   |

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|   |                 |           |         |      |           |
|---|-----------------|-----------|---------|------|-----------|
| Cash surrender value of life insurance policies |                 |           |         |      |           |
| Other Investments                               | 5,932           | -         | 5,932   | -    | 5,932     |
| Investment in Limited Partnership               | 9,204           | -         | 9,204   | -    | 9,204     |
| Accrued interest receivable                     | 4,990           | -         | 4,990   | -    | 4,990     |
| Financial Liabilities:                          |                 |           |         |      |           |
| Deposits:                                       |                 |           |         |      |           |
| Noninterest-bearing                             | \$365,997       | \$365,997 | \$ -    | \$ - | \$365,997 |
| Interest-bearing                                | 808,182         | -         | 808,182 | -    | 808,182   |
| Fed Funds Purchased and Repurchase Agreements   | 5,974           | -         | 5,974   | -    | 5,974     |
| Short-term borrowings                           | -               | -         | -       | -    | -         |
| Long-term borrowings                            | -               | -         | -       | -    | -         |
| Subordinated debentures                         | 30,928          | -         | 11,175  | -    | 11,175    |
| Limited partnership capital commitment          | 962             | -         | 962     | -    | 962       |
| Accrued Interest Payable                        | 186             | -         | 186     | -    | 186       |
|   | Notional Amount |           |         |      |           |
| Off-balance-sheet financial instruments:        |                 |           |         |      |           |
| Commitments to extend credit                    | \$420,707       |           |         |      |           |
| Standby letters of credit                       | 8,703           |           |         |      |           |
| Commercial lines of credit                      | 8,070           |           |         |      |           |

## SIERRA BANCORP AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

## 19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Carrying amount and estimated fair values of financial instruments were as follows (dollars in thousands):

|   | Year Ended December 31, 2012 |   |   |   | Total     |
|---|------------------------------|---|---|---|-----------|
|   | Carrying Amount              | Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |           |
| <b>Financial Assets:</b>                        |                              |   |   |   |           |
| Cash and cash equivalents                       | \$61,818                     | \$61,818  | \$ -                                    | \$ -                                      | \$61,818  |
| Investment securities available for sale        | 380,188                      | 1,809   | 378,379                                 | -   | 380,188   |
| Loans and leases held for investment            | 839,629                      | -   | 873,309                                 | -   | 873,309   |
| Collateral dependent impaired loans             | 27,449                       | -   | 27,449                                  | -   | 27,449    |
| Loans held-for-sale                             | 210                          | 210   | -                                       | -   | 210       |
| Cash surrender value of life insurance policies | 38,007                       | -   | 38,007                                  | -   | 38,007    |
| Other Investments                               | 6,370                        | -   | 6,370                                   | -   | 6,370     |
| Investment in Limited Partnership               | 10,316                       | -   | 10,316                                  | -   | 10,316    |
| Accrued interest receivable                     | 5,095                        | -   | 5,095                                   | -   | 5,095     |
| <b>Financial Liabilities:</b>                   |                              |   |   |   |           |
| <b>Deposits:</b>                                |                              |   |   |   |           |
| Noninterest-bearing                             | \$352,597                    | \$352,597   | \$ -                                    | \$ -                                      | \$352,597 |
| Interest-bearing                                | 821,437                      | -   | 821,911                                 | -   | 821,911   |
| Fed Funds Purchased and Repurchase Agreements   | 1,419                        | -   | 1,419                                   | -   | 1,419     |
| Short-term borrowings                           | 36,650                       | -   | 36,650                                  | -   | 36,650    |
| Long-term borrowings                            | 5,000                        | -   | 5,038                                   | -   | 5,038     |
| Subordinated debentures                         | 30,928                       | -   | 12,141                                  | -   | 12,141    |
| Limited partnership capital commitment          | 962                          | -   | 962                                     | -   | 962       |
| Accrued Interest Payable                        | 304                          | -   | 304                                     | -   | 304       |

|  | Notional Amount |
|--|-----------------|
| Off-balance-sheet financial instruments: |                 |
| Commitments to extend credit             | 225,400         |
| Standby letters of credit                | 6,690           |
| Commercial lines of credit               | 8,539           |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS****BALANCE SHEETS****Years Ended December 31, 2013 and 2012**

(dollars in thousands)

|  | 2013             | 2012             |
|--|------------------|------------------|
| <b>ASSETS</b>  |                  |                  |
| Cash and due from banks                              | \$1,337          | \$1,712          |
| Investments in bank subsidiary                       | 208,326          | 200,497          |
| Investment in Trust subsidiaries                     | 928              | 928              |
| Investment in other securities                       | 2,421            | 1,809            |
| Other assets   | 310              | 263              |
| <b>Total Assets</b>                                  | <b>\$213,322</b> | <b>\$205,209</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>          |                  |                  |
| <b>Liabilities:</b>                                  |                  |                  |
| Other liabilities                                    | \$720            | \$389            |
| Subordinated debentures                              | 30,928           | 30,928           |
| <b>Total liabilities</b>                             | <b>31,648</b>    | <b>31,317</b>    |
| <b>Shareholders' equity:</b>                         |                  |                  |
| Common stock   | 68,428           | 67,044           |
| Retained Earnings                                    | 112,817          | 103,128          |
| Accumulated other comprehensive income, net of taxes | 429              | 3,720            |
| <b>Total shareholders' equity</b>                    | <b>181,674</b>   | <b>173,892</b>   |
| <b>Total liabilities and shareholders' equity</b>    | <b>\$213,322</b> | <b>\$205,209</b> |



**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)****STATEMENTS OF INCOME****Years Ended December 31, 2013, 2012 and 2011**

(dollars in thousands)

|   | 2013             | 2012            | 2011            |
|---|------------------|-----------------|-----------------|
| Income:   |                  |                 |                 |
| Other-than-temporary impairment losses on equity securities       | \$-              | \$-             | \$(1,370)       |
| Dividend from Subsidiary  | 3,000            | -               | -               |
| Other operating income  | 16               | 10              | 21              |
| <b>Total Income</b>   | <b>3,016</b>     | <b>10</b>       | <b>(1,349)</b>  |
| Expense   |                  |                 |                 |
| Salaries and employee benefits                                    | 349              | 254             | 206             |
| Other expenses  | 1,313            | 1,365           | 1,388           |
| <b>Total expenses</b>   | <b>1,662</b>     | <b>1,619</b>    | <b>1,594</b>    |
| Income (loss) before income taxes                                 | 1,354            | (1,609)         | (2,943)         |
| Income tax benefit  | (803)            | (663)           | (1,212)         |
| Income (loss) before equity in undistributed income of subsidiary | 2,157            | (946)           | (1,731)         |
| Equity in undistributed income of subsidiary                      | 11,212           | 9,131           | 9,511           |
| <b>Net income</b>   | <b>\$ 13,369</b> | <b>\$ 8,185</b> | <b>\$ 7,780</b> |

**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**20. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)****STATEMENTS OF CASH FLOWS****Years Ended December 31, 2013, 2012 and 2011**

(dollars in thousands)

|   | 2013     | 2012    | 2011    |
|---|----------|---------|---------|
| Cash flows from operating activities:   |          |         |         |
| Net Income  | \$13,369 | \$8,185 | \$7,780 |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |         |         |
| Undistributed net income of subsidiary  | (11,212) | (9,131) | (9,511) |
| Other-than-temporary impairment loss  | -        | -       | 1,370   |
| (Increase) decrease in other assets   | (75)     | 583     | (140)   |
| Increase in other liabilities   | 106      | 50      | 73      |
| Tax benefit (provision) from equity based compensation                            | 29       | (36)    | 109     |
| Net provided for (used in) operating activities                                   | 2,217    | (349)   | (319)   |
| Cash flows from financing activities:   |          |         |         |
| Expense from the issuance of common stock   | -        | -       | (23)    |
| Stock options exercised   | 1,088    | 51      | 867     |
| Dividends paid  | (3,680)  | (3,385) | (3,368) |
| Net cash used in by financing activities  | (2,592)  | (3,334) | (2,524) |
| Net decrease in cash and cash equivalents   | (375)    | (3,683) | (2,843) |
| Cash and cash equivalents, beginning of year                                      | 1,712    | 5,395   | 8,238   |
| Cash and cash equivalents, end of year  | \$1,337  | \$1,712 | \$5,395 |





**SIERRA BANCORP AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**21. CONDENSED QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

The following table sets forth the Company's results of operations for the four quarters of 2013 and 2012 and is unaudited. In management's opinion, the results of operations reflect all adjustments (which include only recurring adjustments) necessary to present fairly the condensed results for such periods.

|                                     | 2013 Quarter Ended |               |          |           |
|-------------------------------------|--------------------|---------------|----------|-----------|
|                                     | December 31,       | September 30, | June 30, | March 31, |
| Interest income                     | \$13,188           | \$ 12,791     | \$13,090 | \$ 12,716 |
| Interest expense                    | 743                | 790           | 815      | 873       |
| Net interest income                 | 12,445             | 12,001        | 12,275   | 11,843    |
| Provision for loan and lease losses | 1,500              | 800           | 450      | 1,600     |
| Non-interest income                 | 4,607              | 4,319         | 4,022    | 4,115     |
| Non-interest expense                | 10,788             | 11,490        | 10,717   | 11,820    |
| Net income before taxes             | 4,764              | 4,030         | 5,130    | 2,538     |
| Provision for taxes                 | 895                | 663           | 1,331    | 204       |
| Net income                          | \$3,869            | \$ 3,367      | \$3,799  | \$ 2,334  |
| Diluted earnings per share          | \$0.27             | \$ .23        | \$.27    | \$ .16    |
| Cash dividend per share             | \$0.07             | \$ .07        | \$.06    | \$ .06    |
|                                     | 2012 Quarter Ended |               |          |           |
|                                     | December 31,       | September 30, | June 30, | March 31, |
| Interest income                     | \$13,389           | \$ 14,192     | \$13,612 | \$ 13,709 |
| Interest expense                    | 973                | 1,063         | 1,064    | 1,221     |
| Net interest income                 | 12,416             | 13,129        | 12,548   | 12,488    |

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|                                     |         |          |         |          |
|-------------------------------------|---------|----------|---------|----------|
| Provision for loan and lease losses | 3,600   | 4,700    | 3,160   | 2,750    |
| Non-interest income                 | 5,521   | 4,381    | 4,121   | 4,103    |
| Non-interest expense                | 12,637  | 11,496   | 10,482  | 12,041   |
| Net income before taxes             | 1,700   | 1,314    | 3,027   | 1,800    |
| Provision for taxes                 | (398)   | (321)    | 454     | (79)     |
| Net income                          | \$2,098 | \$ 1,635 | \$2,573 | \$ 1,879 |
| Diluted earnings per share          | \$.15   | \$ .12   | \$.18   | \$.13    |
| Cash dividend per share             | \$.06   | \$ .06   | \$.06   | \$.06    |

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## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

The Company's Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13(a) 15(e) as of the end of the period covered by this report (the "Evaluation Date") have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this annual report was being prepared.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized, and reported within the time periods specified by the SEC.

### **Management's Report on Internal Control over Financial Reporting**

Management of the Company is responsible for the preparation, integrity, and reliability of the consolidated financial statements and related financial information contained in this annual report. The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on judgments and estimates of management.

Management has established and is responsible for maintaining effective internal control over financial reporting. The Company's internal control over financial reporting includes those policies and procedures that:

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time. The system contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control - Integrated Framework" published by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2013.

Management is responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations. Management assessed compliance by the Company's insured financial institution, Bank of the Sierra, with the designated laws and regulations relating to safety and soundness. Based on this assessment, management believes that Bank of the Sierra complied, in all significant respects, with the designated laws and regulations related to safety and soundness for the year ended December 31, 2013.

Our assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2013 has been audited by Vavrinek, Trine, Day & Co., LLP, an independent registered public accounting firm, as stated in their report appearing below.

### **Changes in Internal Control**

There were no significant changes in the Company's internal control over financial reporting or in other factors in the fourth quarter of 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

Sierra Bancorp and Subsidiary

Porterville, California

We have audited Sierra Bancorp and Subsidiary's (the Company's) internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in conformity with U.S. generally accepted accounting principles. Because management's assessment and our audit were conducted to also meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of financial statements in accordance with instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and the receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board, the consolidated balance sheets of the Company as of December 31, 2013 and 2012, and the related consolidated statements of operations, shareholders' equity and comprehensive income and cash flows for each of the years in the three year period ended December 31, 2013, and our report dated March 13, 2014 expressed an unqualified opinion on those financial statements.

/s/ Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California

March 13, 2014



**PART IV**

**Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K**

(a) **Exhibits**

| Exhibit # | Description   |
|-----------|---|
| 3.1       | Restated Articles of Incorporation of Sierra Bancorp (1)  |
| 3.2       | Amended and Restated By-laws of Sierra Bancorp (2)  |
| 10.1      | 1998 Stock Option Plan (3)  |
| 10.2      | Salary Continuation Agreement for Kenneth R. Taylor (4)   |
| 10.3      | Salary Continuation Agreement for James C. Holly (4)  |
| 10.4      | Salary Continuation Agreement and Split Dollar Agreement for James F. Gardunio (5)                              |
| 10.5      | Split Dollar Agreement for Kenneth R. Taylor (6)  |
| 10.6      | Split Dollar Agreement and Amendment thereto for James C. Holly (6)   |
| 10.7      | Director Retirement Agreement and Split dollar Agreement for Vincent Jurkovich (6)                              |
| 10.8      | Director Retirement Agreement and Split dollar Agreement for Robert Fields (6)                                  |
| 10.9      | Director Retirement Agreement and Split dollar Agreement for Gordon Woods (6)                                   |
| 10.10     | Director Retirement Agreement and Split dollar Agreement for Morris Tharp (6)                                   |
| 10.11     | Director Retirement Agreement and Split dollar Agreement for Albert Berra (6)                                   |
| 10.12     | 401 Plus Non-Qualified Deferred Compensation Plan (6)   |
| 10.13     | Indenture dated as of March 17, 2004 between U.S. Bank N.A., as Trustee, and Sierra Bancorp, as Issuer (7)      |
| 10.14     | Amended and Restated Declaration of Trust of Sierra Statutory Trust II, dated as of March 17, 2004 (7)          |
| 10.15     | Guarantee Agreement between Sierra Bancorp and U.S. Bank National Association dated as of March 17, 2004 (7)    |
| 10.16     | Indenture dated as of June 15, 2006 between Wilmington Trust Co., as Trustee, and Sierra Bancorp, as Issuer (8) |
| 10.17     | Amended and Restated Declaration of Trust of Sierra Capital Trust III, dated as of June 15, 2006 (8)            |
| 10.18     | Guarantee Agreement between Sierra Bancorp and Wilmington Trust Company dated as of June 15, 2006 (8)           |
| 10.19     | 2007 Stock Incentive Plan (9)   |
| 10.20     | Sample Retirement Agreement Entered into with Each Non-Employee Director Effective January 1, 2007 (10)         |
| 10.21     | Salary Continuation Agreement for Kevin J. McPhaill (10)  |
| 10.22     | First Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (10)                                 |
| 10.23     | Second Amendment to the Salary Continuation Agreement for Kenneth R. Taylor*                                    |
| 11        | Statement of Computation of Per Share Earnings (11)   |
| 21        | Subsidiaries of Sierra Bancorp (12)   |
| 23        | Consent of Vavrinek, Trine, Day & Co., LLP  |
| 31.1      | Certification of Chief Executive Officer (Section 302 Certification)  |
| 31.2      | Certification of Chief Financial Officer (Section 302 Certification)  |
| 32        | Certification of Periodic Financial Report (Section 906 Certification)  |

\* Previously filed.

- (1) Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.
- (2) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.  
Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission (SEC) (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.
- (3) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.
- (4) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.
- (5) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.
- (6) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
- (7) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.
- (8) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
- (9) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
- (10) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.
- (11) Filed as Exhibit 21 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
- (12)

(b) **Financial Statement Schedules**

Schedules to the financial statements are omitted because the required information is not applicable or because the required information is presented in the Company's Consolidated Financial Statements or related notes.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: July 22, 2014 **SIERRA BANCORP,**  
a California corporation

By: */s/ James C. Holly*  
James C. Holly  
Chief Executive Officer  
(Principal Executive Officer)

By: */s/ Kenneth R. Taylor*  
Kenneth R. Taylor  
Executive Vice President &  
Chief Financial Officer  
(Principal Financial and Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.