COMMUNITY WEST BANCSHARES /
Form 10-Q
November 13, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to _________

Commission File Number: 000-23575

COMMUNITY WEST BANCSHARES
(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	77-0446957 (I.R.S. Employer Identification No.)
445 Pine Avenue, Goleta, California (Address of principal executive offices)	93117 (Zip Code)

(805) 692-5821
(Registrant's telephone number, including area code)

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

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

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

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

Number of shares of common stock of the registrant outstanding as of November 9, 2012: 5,989,510 shares

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PART I – FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Community West Bancshares
Consolidated Balance Sheets (unaudited)

(in thousands, except shares)	September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 32,281	$ 22,547
Federal funds sold	25	25
Cash and cash equivalents	32,306	22,572
Time and interest-bearing deposits in other financial institutions	3,890	347
Investment securities available-for-sale, at fair value; amortized cost of $11,930 at September 30, 2012 and $23,350 at December 31, 2011	12,001	23,588
Investment securities held-to-maturity, at amortized cost; fair value of $13,637 at September 30, 2012 and $16,067 at December 31, 2011	12,822	15,335
Federal Home Loan Bank stock, at cost	3,618	4,214
Federal Reserve Bank stock, at cost	1,343	1,343
Loans:		
Loans held for sale, at lower of cost or fair value	62,894	77,303
Loans held for investment, net of allowance for loan losses of $15,055 at September 30, 2012 and $15,270 at December 31, 2011	397,044	455,413
Total loans	459,938	532,716
Foreclosed real estate and repossessed assets	3,761	6,701
Premises and equipment, net	3,112	3,090
Other assets	24,005	23,442
Total assets	$ 556,796	$ 633,348
Liabilities		
Deposits:		
Non-interest-bearing demand	$ 54,466	$ 49,894
Interest-bearing demand	274,894	289,796
Savings	16,443	19,429
Time deposits	114,163	152,143
Total deposits	459,966	511,262
Other borrowings	34,000	61,000
Convertible debentures	7,852	7,852
Other liabilities	4,165	2,608
Total liabilities	505,983	582,722
Stockholders' equity		
Preferred stock, no par value; 10,000,000 shares authorized; 15,600 shares issued and outstanding	15,275	15,074
Common stock, no par value; 20,000,000 shares authorized; 5,989,510 shares issued and outstanding at September 30, 2012 and December 31, 2011	33,449	33,422
Retained earnings	2,047	1,991
Accumulated other comprehensive income, net	42	139
Total stockholders' equity	50,813	50,626
Total liabilities and stockholders' equity	$ 556,796	$ 633,348

See accompanying notes

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Community West Bancshares
Consolidated Income Statements (unaudited)

(in thousands, except per share amounts)	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Interest income				
Loans	$7,324	$8,500	$23,236	$26,409
Investment securities and other	188	268	631	825
Total interest income	7,512	8,768	23,867	27,234
Interest expense				
Deposits	970	1,414	3,287	4,556
Other borrowings and convertible debentures	433	575	1,386	1,744
Total interest expense	1,403	1,989	4,673	6,300
Net interest income	6,109	6,779	19,194	20,934
Provision for loan losses	1,293	4,511	5,176	8,651
Net interest income after provision for loan losses	4,816	2,268	14,018	12,283
Non-interest income				
Other loan fees	302	345	847	986
Gains from loan sales, net	366	104	1,521	271
Document processing fees	109	99	283	312
Loan servicing, net	105	90	180	290
Service charges	98	122	327	366
Other	77	41	300	129
Total non-interest income	1,057	801	3,458	2,354
Non-interest expenses				
Salaries and employee benefits	2,899	3,079	8,526	8,895
Occupancy and equipment expenses	451	487	1,365	1,486
FDIC assessment	311	217	1,046	741
Professional services	372	306	993	757
Advertising and marketing	59	76	218	287
Depreciation and amortization	78	93	231	286
Loss on sale and write-down of foreclosed real estate and repossessed assets	189	1,361	969	2,019
Data processing	127	138	407	393
Other operating expenses	774	1,228	2,880	3,045
Total non-interest expenses	5,260	6,985	16,635	17,909
Income (loss) before provision for income taxes	613	(3,916)	841	(3,272)
Benefit for income taxes	-	(1,609)	-	(1,340)
Net income (loss)	$613	$(2,307)	$841	$(1,932)
Dividends and accretion on preferred stock	253	261	785	785
Net income (loss) applicable to common stockholders	$360	$(2,568)	$56	$(2,717)
Earnings (loss) per common share:				
Basic	$.06	$(0.43)	$.01	$(0.45)
Diluted	$.06	$(0.43)	$.01	$(0.45)
Basic weighted average number of common shares outstanding	5,990	5,988	5,990	5,977
Diluted weighted average number of common shares outstanding	8,233	5,988	8,233	5,977

See accompanying notes

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Community West Bancshares
Consolidated Statements of Comprehensive Income (unaudited)

(in thousands)	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Net income (loss)	$613	$(2,307)	$841	$(1,932)
Other comprehensive loss, net of tax:				
Net unrealized gain (loss) on securities available-for-sale	7	9	(97)	(34)
Comprehensive income (loss)	$620	$(2,298)	$744	$(1,966)

See accompanying notes

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Community West Bancshares
Consolidated Statement of Stockholders' Equity

(in thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at January 1, 2012	$15,074	5,990	$33,422	$1,991	$ 139	$ 50,626
Stock option expense, recognized in earnings			27			27
Comprehensive income:						
Net income				841		841
Change in unrealized gain (loss) Securities available-for-sale, net					(97)	(97)
Dividends and accretion on preferred stock	201			(785)		(584)
Balances at September 30, 2012	$15,275	5,990	$33,449	$2,047	$ 42	$ 50,813

See accompanying notes

Community West Bancshares
Consolidated Statement of Stockholders' Equity

(in thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at January 1, 2011	$14,807	5,916	$33,133	$13,523	$ 179	$ 61,642
Stock option expense, recognized in earnings			22			22
Conversion of debentures		66	231			231
Exercise of stock options		8	25			25
Comprehensive income:						
Net income				(1,932)		(1,932)
Change in unrealized gain (loss) Securities available-for-sale, net					(34)	(34)
Dividends and accretion on preferred stock	200			(785)		(585)
Balances at September 30, 2011	$15,007	5,990	$33,411	$10,806	$ 145	$ 59,369

See accompanying notes

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Community West Bancshares
Consolidated Statements of Cash Flows

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(in thousands)	
Cash flows from operating activities:		
Net income (loss)	$ 841	$ (1,932)
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	5,176	8,651
Depreciation and amortization	231	286
Deferred income taxes	354	659
Stock-based compensation	27	22
Net amortization of discounts and premiums for investment securities	(21)	(47)
Net loss (gain) on:		
Sale and write-downs of foreclosed real estate and repossessed assets	1,076	2,019
Sale of loans held for sale	(1,521)	(271)
Sale of available-for-sale securities	(121)	-
Loan originated for sale and principal collections, net	(2,379)	3,139
Changes in:		
Servicing rights, net of amortization	(121)	86
Other assets	(630)	(5,300)
Other liabilities	1,071	(621)
Net cash provided by operating activities	3,983	6,691
Cash flows from investing activities:		
Purchase of available-for-sale securities	-	(6,772)
Principal pay downs and maturities of available-for-sale securities	7,446	2,069
Proceeds from sale of available-for-sale securities	4,137	-
Purchase of Federal Reserve stock	-	(21)
Redemptions of Federal Home Loan Bank stock	596	612
Principal pay downs and maturities of held-to-maturity securities	2,493	5,287
Loan originations and principal collections, net	65,185	14,064
Proceeds from sale of foreclosed real estate and repossessed assets	8,181	5,227
Net (increase) decrease in time and interest-bearing deposits in other financial institutions	(3,543)	50
Purchase of premises and equipment, net	(253)	(389)
Net cash provided by investing activities	84,242	20,127
Cash flows from financing activities:		
Dividends and accretion on preferred stock	(195)	(585)
Exercise of stock options	-	25
Net (decrease) increase in demand deposits and savings accounts	(13,316)	35,081
Net decrease in time certificates of deposit	(37,980)	(57,438)
Proceeds from Federal Home Loan Bank advances	-	11,000
Repayment of Federal Home Loan Bank and FRB advances	(27,000)	(10,000)
Net cash used in financing activities	(78,491)	(21,917)
Net increase in cash and cash equivalents	9,734	4,901
Cash and cash equivalents, beginning of year	22,572	6,226
Cash and cash equivalents, end of period	$ 32,306	$ 11,127

Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$ 4,631	$ 6,324
Cash paid for income taxes	$ 712	$ 1,941
Supplemental Disclosure of Noncash Investing Activity:		
Transfers to foreclosed real estate and repossessed assets	$ 6,317	$ 5,195
Supplemental Disclosure of Noncash Financing Activity:		
Preferred stock dividends declared, not paid	$ 388	$ -

See accompanying notes

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COMMUNITY WEST BANCSHARES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The interim consolidated financial statements reflect all adjustments and reclassifications that, in the opinion of management, are necessary for the fair presentation of the results of operations and financial condition for the interim period. The unaudited consolidated financial statements include Community West Bancshares (“CWBC”) and its wholly-owned subsidiary, Community West Bank, N.A. (“CWB” or the “Bank”). CWBC and CWB are referred to herein collectively as the “Company”. The accompanying unaudited Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and with the instructions to Form 10-Q and Article 8-03 of Regulation S-X promulgated by the Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and footnotes required for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been reflected in the financial statements. The results of operations for the nine-month period ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year.

These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Loans Held for Investment – Loans are recognized at the principal amount outstanding, net of unearned income, loan participations and amounts charged off. Unearned income includes deferred loan origination fees reduced by loan origination costs. Unearned income on loans is amortized to interest income over the life of the related loan using the level yield method. The following is a description of the loan categories held for investment.

Commercial Loans

In addition to traditional term commercial loans made to business customers, the Company grants revolving business lines of credit. Under the terms of the revolving lines of credit, the Company grants a maximum loan amount, which remains available to the business during the loan term. Generally, as part of the loan requirements, the business agrees to maintain its primary banking relationship with the Company. The collateral for these loans typically are secured by UCC-1 financing statements, real estate and personal guarantees. The Company does not extend material loans of this type in excess of two years.

Commercial Real Estate

Commercial real estate and construction loans are primarily made for the purpose of purchasing, improving or constructing single-family residences, commercial or industrial properties. This loan category also includes SBA 504 loans and land loans.

A substantial portion of the Company's real estate construction loans are first and second trust deeds on the construction of owner-occupied single family dwellings. The Company also makes real estate construction loans on commercial properties. These consist of first and second trust deeds collateralized by the related real property. Construction loans are generally written with terms of six to eighteen months and usually do not exceed a loan to appraised value of 80%. All construction loans require UCC-1 filings to secure on-site building materials, including but not limited to lumber, plumbing fixtures and dry wall.

Commercial and industrial real estate loans are secured by nonresidential property. Office buildings or other commercial property primarily secure these loans. Loan to appraised value ratios on nonresidential real estate loans are generally restricted to 75% of appraised value of the underlying real property if occupied by the owner or owner's business; otherwise, these loans are generally restricted to 70% of appraised value of the underlying real property.

SBA 504 loans are made in conjunction with Certified Development Companies. These loans are granted to purchase or construct real estate or acquire machinery and equipment. The loan is structured with a conventional first trust deed provided by a private lender and a second trust deed which is funded through the sale of debentures. The predominant structure is terms of 10% down payment, 50% conventional first loan and 40% debenture. Construction loans of this type must provide additional collateral to reduce the loan-to-value to approximately 75%.

Conventional and investor loans are sometimes funded by our secondary-market partners and the Company receives a premium for these transactions.

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SBA Loans
SBA loans consist of 7(a) and Business and Industry loans (“B&I”). The 7(a) loan proceeds are used for working capital, machinery and equipment purchases, land and building purposes, leasehold improvements and debt refinancing. At present, the SBA guarantees as much as 85% on loans up to $150,000 and 75% on loans more than $150,000. In certain instances, the Company sells a portion of the loans, however, under the SBA 7(a) loan program, the Company is required to retain a minimum of 5% of the principal balance of each loan it sells into the secondary market.

Agricultural Loans for real estate and operating lines

The Company has expanded its agricultural lending program for agricultural land, agricultural operational lines, and agricultural term loans for crops, equipment and livestock. The primary product is supported by guarantees issued from the U.S. Department of Agriculture (“USDA”), Farm Service Agency (“FSA”), and the USDA Business and Industry loan program. The FSA loans typically issue a 90% guarantee up to $1,214,000 for 40 years or 480 months. The rates are typically fixed for 5 years and reset on the 61st month. The agricultural term loans and operating lines can be either fixed or variable. The operating lines are committed up to 7 years or 84 months and the term loans can be for 7 years or 84 months.

The USDA Business and Industry loans have up to 80% guarantee on loan amounts up to $5,000,000. These loans can be utilized for rural commercial real estate and equipment. The loans can be up to 30 years or 360 months. The rates can be fixed or variable.

Single Family Real Estate Loans
The Company originates loans that consist of first and second mortgage loans secured by trust deeds on one-to-four family homes. These loans are made to borrowers for purposes such as purchasing a home, refinancing an existing home, interest rate reduction, home improvement, or debt consolidation. Generally, these loans are underwritten to specific investor guidelines and are committed for sale to that investor. Although the majority of these loans are sold servicing released into the secondary market, a relatively small percentage is held as part of the Company’s portfolio.

Manufactured Housing Loans
The Company originates loans secured by manufactured homes located in approved mobile home parks in our primary lending area of Santa Barbara and Ventura Counties as well as along the California coast. The loans are serviced internally and are originated under one of two programs: fixed rate loans written for terms of 10 to 20 years; and adjustable rate loans written for a term of 30 years with the initial interest rates fixed for the first 5 or 10 years and then adjusting annually subject to caps and floors.

HELOC
The Company provides lines of credit collateralized by residential real estate, home equity lines of credit (“HELOC”), for consumer related purposes. Typically, HELOCs are collateralized by a second deed of trust. The combined loan-to-value, first trust deed and second trust deed, are not to exceed 75% on all new HELOCs.

Other Installment Loans
Installment loans consist of automobile and general-purpose loans made to individuals. These loans are primarily fixed rate.

Provision and Allowance for Loan Losses – The Company maintains a detailed, systematic analysis and procedural discipline to determine the amount of the allowance for loan losses (“ALL”). The ALL is based on estimates and is intended to be adequate to provide for probable losses inherent in the loan portfolio. This process involves deriving probable loss estimates that are based on migration analysis/historical loss rates and qualitative factors that are based on management's judgment. The migration analysis and historical loss rate calculations are based upon the annualized loss rates utilizing a twelve-quarter loss history. Migration analysis is utilized for the Commercial Real Estate, Commercial, SBA, HELOC, Single Family Residential, and Consumer portfolios. The historical loss rate method is utilized for the homogeneous loan categories, primarily the Manufactured Housing portfolio. The migration analysis takes into account the risk rating of loans that are charged off in each loan category. Loans that are considered Doubtful are typically charged off. The following is a description of the characteristics of loans graded Pass, Special Mention, Substandard, Doubtful and Loss. Loan ratings are reviewed as part of our normal loan monitoring process, but, at a minimum, updated on an annual basis.

Pass

Loans rated in this category are acceptable loans, appropriately underwritten, bearing an ordinary risk of loss to the Company. Loans in this category are loans to quality borrowers with financial statements presenting a good primary source as well as an adequate secondary source of repayment. In the case of individuals, borrowers deserving of this rating are quality borrowers demonstrating a reasonable level of secure income, a net worth adequate to support the loan and presenting a good primary source as well as an adequate secondary source of repayment.

Special Mention

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

Substandard

A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful

A loan classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

Loss

Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable loans is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this loan even though partial recovery may be affected in the future. Losses are taken in the period in which they surface as uncollectible. The following is the Company's policy regarding charging off loans by loan categories.

Commercial, Commercial Real Estate and SBA Loans

Charge-offs on these loan categories are taken as soon as all or a portion of any loan balance is deemed to be uncollectible. A loan is considered uncollectible when the debtor is delinquent in principal or interest repayment 90 days or more and, in the opinion of the Company, improvement in the debtor's ability to repay the debt in a timely manner is doubtful. Also, collateral value is insufficient to cover the outstanding indebtedness. Loans secured by real estate on which principal or interest is due and unpaid for 90 days are evaluated for possible charge-down and placed on non-accrual. Generally, loan balances are charged-down to the fair value of the property, if, based on a current appraisal, an apparent deficiency exists. In the event there is no perceived equity, the loan is charged-off in full like any other unsecured loan, which is not secured and over 90 days.

Single Family Real Estate, HELOC's and Manufactured Housing Loans

Consumer loans and residential mortgages secured by one-to-four family residential properties, HELOC and manufactured housing loans in which principal or interest is due and unpaid for 90 days, are evaluated for possible charge-down. Loan balances are charged-down to the fair value of the property if, based on a current appraisal, an apparent deficiency exists. In the event there is no perceived equity, the loan is generally charged-off in full like any other consumer loan, which is not secured and unpaid over 90-120 days.

Consumer Loans
All consumer loans (excluding real estate mortgages, home equity loans and savings secured loans) are charged-off or charged-down to net recoverable value before becoming 120 days or 5 payments delinquent. Consumer losses are identified well before the 120 day limit whenever possible. Net recoverable value can only be determined if the collateral is in the Company's possession, and its liquidation value can be verified and realized in the near term.

The second component of the ALL covers qualitative factors related to non-impaired loans. The qualitative allowance on each of the loan pools is based on the following factors:

- Concentrations of credit
- International risk
- Trends in volume, maturity, and composition
- Off-balance sheet
- Volume and trend in delinquency
- Economic conditions
- Outside exams
- Geographic distance
- Policy and procedures
- Staff experience and ability

The ALL calculation for the different loan portfolios is as follows:

- Commercial Real Estate, Commercial, SBA, HELOC, Single Family Residential, and Consumer – Migration analysis combined with risk rating is used to determine the required allowance for all non-impaired loans. In addition, the migration results are adjusted based upon the qualitative factors previously discussed that affect this specific portfolio category. Reserves on impaired loans are determined based upon the individual characteristics of the loan.
- Manufactured Housing – The allowance is calculated on the basis of loss history and risk rating, which is primarily a function of delinquency. In addition, the migration results are adjusted based upon the qualitative factors previously discussed that affect this specific portfolio.

The Company evaluates and individually assesses for impairment loans generally greater than $500,000, classified as substandard or doubtful in addition to loans either on nonaccrual, considered a troubled debt restructuring (“TDR”) or when other conditions exist which lead management to review for possible impairment. The $500,000 threshold for the evaluation of individual loans for impairment represents a change instituted in the second quarter of 2012. Previously, the threshold for the evaluation of loans for impairment was $100,000. Measurement of impairment on impaired loans is determined on a loan-by-loan basis and in total establishes a specific reserve for impaired loans. The amount of impairment is determined by comparing the recorded investment in each loan with its value measured by one of three methods.

- The expected future cash flows are estimated and then discounted at the effective interest rate.
- The value of the underlying collateral net of selling costs. Selling costs are estimated based on industry standards, the Company’s actual experience or actual costs incurred as appropriate. When evaluating real estate collateral, the Company typically uses appraisals or valuations, no more than twelve months old at time of evaluation. When evaluating non-real estate collateral securing the loan, the Company will use audited financial statements or appraisals no more than twelve months old at time of evaluation. Additionally for both real estate and non-real estate collateral, the Company may use other sources to determine value as deemed appropriate.
- The loan’s observable market price.

Interest income is not recognized on impaired loans except for limited circumstances in which a loan, although impaired, continues to perform in accordance with the loan contract and the borrower provides financial information to support maintaining the loan on accrual.

The Company determines the appropriate ALL on a monthly basis and updates the qualitative factors quarterly. Any differences between estimated and actual observed losses from the prior month are reflected in the current period in determining the appropriate ALL determination and adjusted as deemed necessary. The review of the adequacy of the allowance takes into consideration such factors as concentrations of credit, changes in the growth, size and composition of the loan portfolio, overall and individual portfolio quality, review of specific problem loans, collateral, guarantees and economic and environmental conditions that may affect the borrowers' ability to pay and/or the value of the underlying collateral. Additional factors considered include: geographic location of borrowers, changes in the Company's product-specific credit policy and lending staff experience. These estimates depend on the outcome of future events and, therefore, contain inherent uncertainties.

The Company's ALL is maintained at a level believed adequate by management to absorb known and inherent probable losses on existing loans. A provision for loan losses is charged to expense. The allowance is charged for losses when management believes that full recovery on the loan is unlikely.

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The Company has outsourced and centralized appraisal management processes that track and monitor appraisals, appraisal reviews and other valuations. The centralization focus is to ensure the use of qualified and independent appraisers capable of providing reliable real estate values in the context of ever changing market conditions. The review process is monitored to ensure application of the appropriate appraisal methodology, agreement with the interpretation of market data and the resultant real estate value. The process also provides the means of tracking the performance quality of the appraisers on the Company's approved appraiser list. Any loan evaluation that results in the Company determining that elevated credit risk and/or default risk exists and also exhibits a lack of a timely valuation of the collateral or apparent collateral value deterioration is reappraised and reevaluated to determine the current extent of any change in collateral value and credit risk. A similar review process is conducted quarterly on all classified and criticized real estate credits to determine the timeliness and adequacy of the real estate collateral value.

Foreclosed Real Estate and Repossessed Assets – Foreclosed real estate and other repossessed assets are recorded at fair value at the time of foreclosure less estimated costs to sell. Any excess of loan balance over the fair value less estimated costs to sell of the other assets is charged-off against the allowance for loan losses. Any excess of the fair value less estimated costs to sell over the loan balance is recorded as a loan loss recovery to the extent of the loan loss previously charged-off against the allowance for loan losses; and, if greater, recorded as a gain on foreclosed real estate. Subsequent to the legal ownership date, management periodically performs a new valuation and the asset is carried at the lower of carrying amount or fair value less estimated costs to sell. Operating expenses or income, and gains or losses on disposition of such properties, are recorded in current operations.

Income Taxes – The Company uses the asset and liability method, which recognizes a liability or asset representing the tax effects of future deductible or taxable amounts that have been recognized in the consolidated financial statements. Due to tax regulations, certain items of income and expense are recognized in different periods for tax return purposes than for financial statement reporting. These items represent "temporary differences." Deferred income taxes are recognized for the tax effect of temporary differences between the tax basis of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. A valuation allowance is established for deferred tax assets if, based on weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets may not be realized.

As of December 31, 2011, the deferred tax asset, net of valuation allowance, totaled $306,000. Management evaluates the Company's deferred tax asset for recoverability using a consistent approach which considers the relative impact of negative and positive evidence, including the Company's historical profitability and projections of future taxable income. The Company is required to establish a valuation allowance for deferred tax asset and record a charge to income if Management determines, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax asset may not be realized.

For the three-year period ended December 31, 2011, the Company was in a cumulative pretax loss position. For purposes of establishing a deferred tax valuation allowance, this cumulative pretax loss position was considered significant, objective evidence that the Company may not be able to realize some portion of the deferred tax asset in the future. As a result, the Company established a valuation allowance for the deferred tax asset of $6.7 million as of December 31, 2011. The net deferred tax asset of $306,000 represented the estimated amount of tax that Management has determined may be recoverable through carryback of tax losses to prior years.

Net income represents positive evidence for the reduction of the deferred tax valuation allowance. Based on net income of $841,000 for the first nine months ended September 30, 2012, the deferred tax valuation allowance was reduced by $354,000 to $6.3 million at September 30, 2012. The net deferred tax asset increased from $306,000 at December 31, 2011 to $660,000 at September 30, 2012.

The Company is subject to the provisions of ASC 740, Income Taxes (ASC 740). ASC 740 prescribes a more-likely-than-not threshold for the financial statement recognition of uncertain tax positions. ASC 740 clarifies the accounting for income taxes by prescribing a minimum recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. On a quarterly basis, the Company evaluates income tax accruals in accordance with ASC 740 guidance on uncertain tax positions.

Earnings Per Share - Basic earnings per common share is computed using the weighted average number of common shares outstanding for the period divided into the net income (loss) applicable to common shareholders. Diluted earnings per share include the effect of all dilutive potential common shares for the period. Potentially dilutive common shares include stock options, warrants and shares that could result from the conversion of debenture bonds.

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Recent Accounting Pronouncements –In May 2011, the FASB issued ASU No. 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the balance sheet but whose fair value must be disclosed. The provisions of ASU No. 2011-04 are effective for the Company's interim reporting period beginning on or after December 15, 2011. The adoption of ASU No. 2011-04 did not have a material impact on the Company's balance sheets and statements of income.

In June 2011, the FASB issued ASU No. 2011-05, "Presentation of Comprehensive Income." The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income ("OCI") either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of OCI along with a total for OCI, and a total amount for comprehensive income. The statement(s) are required to be presented with equal prominence as the other primary financial statements. ASU No. 2011-05 eliminates the option to present the components of OCI as part of the statement of changes in shareholders' equity but does not change the items that must be reported in OCI or when an item of OCI must be reclassified to net income. The provisions of ASU No. 2011-05 are effective for the Company's interim reporting period beginning on or after December 15, 2011, with retrospective application required. The adoption of ASU No. 2011-05 resulted in presentation changes to the Company's statements of income and the addition of a statement of comprehensive income. The adoption of ASU No. 2011-05 had no impact on the Company's balance sheets.

In December 2011, the FASB issued ASU 2011-12 "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05". The amendments are being made to allow the FASB time to re-deliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and OCI for all periods presented. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. The adoption of ASU 2011-12 will have no impact on the Company's balance sheets.

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2. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities are as follows:

September 30, 2012	(in thousands)			
		Gross	Gross	
	Amortized	Unrealized	Unrealized	Fair
Available-for-sale securities	Cost			