

Oak Valley Bancorp
Form 10-Q
November 14, 2008
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x

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

For the quarterly period ended September 30, 2008

OR

o

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

California
State or other jurisdiction of
incorporation or organization

26-2326676
I.R.S. Employer
Identification No.

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

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Issuer's telephone number

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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 Exchange Act). Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: **7,658,252 shares of common stock outstanding as of September 30, 2008.**

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September 30, 2008

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Table of Contents**OAK VALLEY BANCORP****CONDENSED BALANCE SHEETS**

	September 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Cash and due from banks	\$ 10,263,546	\$ 10,397,951
Federal funds sold	375,000	3,805,000
Cash and cash equivalents	10,638,546	14,202,951
Securities available for sale	32,899,653	33,372,624
Loans, net of allowance for loan loss of \$4,649,723 in 2008 and \$4,506,753 in 2007	411,032,444	382,264,026
Bank premises and equipment, net	10,244,896	10,108,620
Other real estate owned	4,364,693	
Accrued interest and other assets	20,930,919	14,310,569
	\$ 490,111,151	\$ 454,258,790
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits	\$ 365,229,560	\$ 377,347,776
Accrued interest and other liabilities	2,730,165	3,549,624
FHLB advances	78,000,000	31,000,000
Total liabilities	445,959,725	411,897,400
Shareholders' equity		
Preferred stock, no par value; 10,000,000 shares authorized, none issued or outstanding		
Common stock, no par value; 10,000,000 shares authorized and 7,658,252 shares and 7,607,780 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	23,019,218	22,843,171
Additional paid-in capital	1,904,073	1,748,380
Retained earnings	19,148,174	17,723,646
Accumulated other comprehensive income, net of tax	79,961	46,193
Total shareholders' equity	44,151,426	42,361,390
	\$ 490,111,151	\$ 454,258,790

See accompanying notes

Table of Contents**OAK VALLEY BANCORP****CONDENSED STATEMENTS OF EARNINGS (UNAUDITED)**

	3 MONTHS ENDED SEPTEMBER 30,		9 MONTHS ENDED SEPTEMBER 30,	
	2008	2007	2008	2007
Interest and fees on loans	\$ 7,040,391	\$ 7,632,002	\$ 20,750,394	\$ 22,765,409
Interest on securities available for sale	403,064	409,574	1,205,973	1,203,435
Interest on federal funds sold	4,254	54,543	13,831	140,877
Interest on deposits with banks	566	832	1,592	3,621
Total interest income	7,448,275	8,096,951	21,971,790	24,113,342
Deposits	1,700,868	2,986,791	5,568,872	8,573,026
FHLB advances	455,441	243,046	1,214,339	1,389,833
Federal funds purchased	238	8,067	7,554	36,979
Total interest expense	2,156,547	3,237,904	6,790,765	9,999,838
Net interest income	5,291,728	4,859,047	15,181,025	14,113,504
Provision for loan losses	602,000	145,000	1,187,000	435,000
Net interest income after provision for loan losses	4,689,728	4,714,047	13,994,025	13,678,504
Service charges on deposits	337,264	267,723	984,556	807,853
Earnings on cash surrender value of life insurance	99,241	43,615	249,103	102,231
Mortgage commissions	23,410	14,404	94,859	166,868
Other	174,557	170,410	561,250	463,928
Total Non-interest income	634,472	496,152	1,889,768	1,540,880
Salaries and employee benefits	2,319,467	2,121,404	7,200,869	6,274,485
Occupancy expenses	675,728	603,483	2,015,674	1,656,663
Data processing fees	193,009	169,036	562,007	385,131
Telephone expenses	74,360	64,226	218,742	188,255
Other operating expenses	1,272,645	614,323	3,125,421	1,792,342
Total Non-interest expense	4,535,209	3,572,472	13,122,713	10,296,876
Earnings before provision for income taxes	788,991	1,637,727	2,761,080	4,922,508
Provision for income taxes	239,595	668,270	883,150	1,948,270
NET EARNINGS	\$ 549,396	\$ 969,457	\$ 1,877,930	\$ 2,974,238
Net Earnings Per Share	\$ 0.07	\$ 0.13	\$ 0.25	\$ 0.41
Net Earnings Per Share - assuming dilution	\$ 0.07	\$ 0.13	\$ 0.24	\$ 0.40

See accompanying notes

Table of Contents**OAK VALLEY BANCORP****CONDENSED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)****YEAR ENDED DECEMBER 31, 2007 AND THE NINE MONTH PERIOD ENDED SEPTEMBER 30, 2008**

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Comprehensive Income	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balances, January 1, 2007	7,103,243	17,648,475	\$ 1,502,004	\$ 15,243,222	\$	\$ (204,772)	\$ 34,188,929
Stock offering	456,431	5,020,739					5,020,739
Stock offering expense		(25,000)					(25,000)
Stock options exercised	48,106	198,957					198,957
Tax benefit of stock options exercised			116,303				116,303
Cash dividends (\$0.19 per share)				(1,444,697)			(1,444,697)
Stock based compensation			130,073				130,073
Comprehensive income							
Net changes in unrealized gain on available-for-sale securities (net of income tax of \$163,169)					\$ 250,965	250,965	250,965
Net earnings				3,925,121	3,925,121		3,925,121
Comprehensive income					\$ 4,176,086		
Balances, December 31, 2007	7,607,780	22,843,171	\$ 1,748,380	\$ 17,723,646		\$ 46,193	\$ 42,361,390
Stock options exercised	50,472	176,047					176,047
Tax benefit of stock options exercised			54,195				54,195
Cash dividends (\$0.05 per share)				(382,943)			(382,943)
Stock based compensation			101,498				101,498
Cumulative effect of adopting EITF 06-04 (net of tax of \$49,383)				(70,459)			(70,459)
Comprehensive income							
Net changes in unrealized gain on available-for-sale securities (net of income tax of \$21,956)					\$ 33,768	33,768	33,768
Net earnings				1,877,930	1,877,930		1,877,930
Comprehensive income					\$ 1,911,698		
Balances, September 30, 2008	7,658,252	23,019,218	\$ 1,904,073	\$ 19,148,174		\$ 79,961	\$ 44,151,426

Table of Contents**OAK VALLEY BANCORP****CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	9 MONTHS ENDED SEPTEMBER 30,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	\$ 1,877,930	\$ 2,974,238
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision for loan losses	1,187,000	435,000
Depreciation, amortization and accretion, net	835,826	739,164
Stock-based compensation expense	101,498	97,531
Excess tax benefits from stock-based payment arrangements	(54,195)	(125,252)
Gain on sale of premises and equipment	(2,428)	(14,400)
Decrease (increase) in accrued interest receivable	100,599	(62,496)
Decrease in accrued interest payable and other liabilities	(939,301)	(5,262,914)
Increase in other assets	(1,899,326)	(872,418)
Net cash from operating activities	1,207,603	(2,091,547)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of securities available for sale	(6,459,330)	(12,713,175)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	6,995,919	14,580,990
Net increase in loans	(34,320,111)	(7,737,243)
Purchase of BOLI policies	(4,740,000)	0
Proceeds from sales of premises and equipment	47,778	14,400
Net purchases of premises and equipment	(1,025,346)	(5,430,134)
Net cash from investing activities	(39,501,090)	(11,285,162)
CASH FLOWS FROM FINANCING ACTIVITIES:		
FHLB advanced funds	205,463,000	97,784,000
FHLB payments	(158,463,000)	(107,434,000)
Federal funds advances	63,175,000	(144,110,000)
Federal funds payments	(63,175,000)	143,160,000
Dividends paid	(382,943)	(1,444,697)
Net increase in demand deposits and savings accounts	6,249,207	28,906,000
Net decrease in time deposits	(18,367,424)	(21,278,141)
Excess tax benefits from stock-based payment arrangements	54,195	125,252
Proceeds from sale of common stock and exercise of stock options	176,047	5,188,736
Net cash from financing activities	34,729,082	897,150
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,564,405)	(12,479,559)
CASH AND CASH EQUIVALENTS, beginning of period	14,202,951	27,819,177
CASH AND CASH EQUIVALENTS, end of period	\$ 10,638,546	\$ 15,339,618

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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the year for:

Interest	\$	7,860,601	\$	10,457,367
Income taxes	\$	890,000	\$	1,776,000

NON-CASH INVESTING ACTIVITIES:

Real estate acquired through foreclosure	\$	4,364,693	\$	0
Net change in unrealized gain/loss on available-for-sale securities	\$	55,724	\$	88,548

NON-CASH INVESTING ACTIVITIES:

Tax benefit from stock options exercised	\$	54,195	\$	125,252
Cumulative effect of adopting EITF 06-04	\$	119,842	\$	0

See accompanying notes

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OAK VALLEY BANCORP

NOTES TO CONDENSED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

On July 3, 2008 (the Effective Date), a bank holding company reorganization was completed whereby Oak Valley Bancorp became the parent holding company for Oak Valley Community Bank (the Bank). On the Effective Date, each outstanding share of the Bank was converted into one share of Oak Valley Bancorp and the Bank became a wholly-owned subsidiary of the holding company. The condensed financial statements and accompanying footnotes are presented as if the reorganization occurred as of the earliest periods presented and are consistent with those of Oak Valley Community Bank, since prior to the Effective Date, Oak Valley Bancorp had no material assets, liabilities or operations.

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America (GAAP) and with general practices within the banking industry. In preparing financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the estimation of compensation expense related to stock options granted to employees and directors, and valuation allowances associated with deferred tax assets, the recognition of which are based on future taxable income.

The interim financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the nine month period ended September 30, 2008 are not necessarily indicative of the results of a full year's operations. For further information, refer to the audited financial statements and footnotes included in the Company's annual report for the year ended December 31, 2007.

NOTE 2 CURRENT ACCOUNTING PRONOUNCEMENTS

Change in accounting principle During 2008 in conjunction with the Company's filing of a Form 10 registration statement with the SEC, the Company made a change in accounting principle and adopted Staff Accounting Bulletin (SAB) No. 108. As a result, the Company recorded adjustments to its deferred tax assets and also recorded a liability related to lease agreements that include fixed rent escalation clauses.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 154, *Accounting Changes and Correction of Errors*, the Company adjusted its financial statements to apply SAB No. 108 retrospectively. As a result of the change in accounting principle, the following adjustments to the financial statements were made:

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- Accrued interest and other assets decreased by \$144,586 at December 31, 2007.
- Accrued interest and other liabilities increased by \$134,030 at December 31, 2007.
- Retained earnings decreased by \$278,616 at December 31, 2007.
- Occupancy expense increased \$42,107 for the year ended December 31, 2007.
- Income tax expense increased \$1,270 for the year ended December 31, 2007.

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OAK VALLEY BANCORP

NOTES TO CONDENSED FINANCIAL STATEMENTS

- Net income decreased \$43,227 and basic and diluted earnings per share decreased \$.01 per share to \$.53 and \$.52 per share, respectively, for the year ended December 31, 2007.

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement No. 157, Fair Value Measurements (SFAS 157). SFAS No. 157 defines the fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. We adopted SFAS No. 157 as of January 1, 2008 and the adoption did not have a material impact on the financial condition or results of operations of the Company.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115. SFAS 159 permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of SFAS 159 are elective; however, the amendment to SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, applies to all entities with available for sale or trading securities. For financial instruments elected to be accounted for at fair value, an entity will report the unrealized gains and losses in earnings. We adopted SFAS No. 159 on January 1, 2008. We chose not to elect the option to measure the fair value of eligible financial assets and liabilities at fair value.

In September 2006 the Emerging Issues Task Force (EITF) ratified EITF issue 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspect of Endorsement Split-Dollar Life Insurance Arrangements. This ruling provides that the Company should recognize a liability for future benefits based on the agreements held with employees. The issue was effective for fiscal years beginning after December 17, 2007. The Company adopted this pronouncement effective January 1, 2008 and has recorded an initial liability of \$119,842 with an offsetting adjustment to retained earnings of \$70,459 and deferred taxes of \$49,383, pursuant to this accounting pronouncement.

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Loan totals were as follows:

	SEPTEMBER 30, 2008	DECEMBER 31, 2007
Loans		
Commercial real estate	\$ 240,059,833	\$ 208,309,072
Commercial	40,308,203	45,496,794
Real estate construction	90,631,577	83,173,030
Agriculture	23,886,459	31,429,970
Residential real estate and consumer	21,778,213	19,400,263
Total loans	416,664,285	387,809,129
Less:		
Deferred loan fees and costs, net	(982,118)	(1,038,350)
Allowance for loan losses	(4,649,723)	(4,506,753)
Net loans	\$ 411,032,444	\$ 382,264,026

Changes in the allowance for loan losses were as follows:

	SEPTEMBER 30, 2008	DECEMBER 31, 2007
Balance, beginning of year	\$ 4,506,753	\$ 4,341,062
Provision charged to operations	1,187,000	555,000
Loans charged off	(1,032,913)	(401,510)
Loan recoveries	4,491	4,275
Reclassification of reserve related to off-balance-sheet commitments	(15,608)	7,926
Balance, end of period	\$ 4,649,723	\$ 4,506,753

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OAK VALLEY BANCORP

NOTES TO CONDENSED FINANCIAL STATEMENTS

NOTE 3 LOANS (CONTINUED)

Effective July 1, 2008, the expense associated with the allowance for off-balance-sheet commitments is recorded separately as a component of other expenses. The \$15,608 reclassification from the allowance for loan losses to other liabilities is a non-recurring adjustment.

The total recorded investment in impaired loans at September 30, 2008, was \$2,175,362 which had a loan loss reserve of \$305,807. The total recorded investment in impaired loans at December 31, 2007, was \$9,087,462 which had a loan loss reserve of \$461,694. No interest income was recognized on impaired loans, while considered impaired during 2008 and 2007. As of September 30, 2008 we had no funding commitments on impaired loans.

NOTE 4 OTHER REAL ESTATE OWNED

As of September 30, 2008, seven loans with outstanding balances of \$4,364,693 were reclassified to other real estate owned.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of carrying amount of the loan or fair value of the property at the date of foreclosure less selling costs. Subsequent to foreclosure, valuations are periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure. Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

NOTE 5 – OTHER POST-RETIREMENT BENEFIT PLANS

During January 2008, the Bank has awarded certain officers a salary continuation plan (the Plan). Under the Plan, the participants will be provided with a fixed annual retirement benefit for twenty years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Bank purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Bank and are available to satisfy the Bank's general creditors.

During January 2008 the Bank awarded two of its directors a director retirement plan (DRP). Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Bank is also responsible for certain pre-retirement death benefits under

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the DRP. In connection with the implementation of the DRP, the Bank purchased single premium life insurance policies on the life of each director covered under the DRP. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Bank and are available to satisfy the Bank's general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Bank accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Bank's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years.

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OAK VALLEY BANCORP

NOTES TO CONDENSED FINANCIAL STATEMENTS

During January 2008, the Bank entered into split-dollar life insurance agreements with certain officers. In connection with the implementation of the split-dollar agreements, the Bank purchased single premium life insurance policies on the life of each of the officers covered by the split-dollar life insurance agreements. The Bank is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies was \$9,768,990 and \$4,749,230 at September 30, 2008 and December 31, 2007, respectively.

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SFAS No. 157, Fair Value Measurements, which the Company adopted effective January 1, 2008, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1: Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

Assets and liabilities measured at fair value on a recurring and non-recurring basis are summarized below:

	Fair Value Measurements at September 30, 2008 Using			
	September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities	\$ 32,899,653	\$	\$ 32,899,653	\$
Assets and liabilities measured on a non-recurring basis:				
Impaired Loans	\$ 1,867,372	\$	\$	\$ 1,867,372

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The fair value of securities available for sale equals quoted market price, if available. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities. Changes in fair market value are recorded in other comprehensive income net of tax. SFAS No. 157

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applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral. At September 30, 2008, impaired loans had a principal balance of \$2,175,362, with a valuation allowance of \$305,807 at September 30, 2008. Upon being classified as impaired, charge offs were taken to reduce the balance of each loan to an estimate of the collateral fair market value less cost to dispose. This estimate was a level 3 valuation. There was no direct impact on the income statement. The charge-offs were recorded as a debit to the allowance for loan losses.

NOTE 7 EARNINGS PER SHARE

The Bank computes earnings per share (EPS) in accordance with SFAS No. 128, *Earnings per Share*. SFAS No. 128 requires the presentation of basic EPS, which does not consider the effect of common stock equivalents and diluted EPS, which considers all dilutive common stock equivalents.

In thousands (except share and per share amounts)	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2008	2007	2008	2007
BASIC EARNINGS PER SHARE				
Net income	\$ 549,396	\$ 969,457	\$ 1,877,930	\$ 2,974,238
Weighted average shares outstanding	7,658,252	7,567,719	7,636,687	7,283,187
Net income per share	\$ 0.07	\$ 0.13	\$ 0.25	\$ 0.41
DILUTED EARNINGS PER SHARE				
Net income	\$ 549,396	\$ 969,457	\$ 1,877,930	\$ 2,974,238
Weighted average shares outstanding	7,658,252	7,567,719	7,636,687	7,283,187
Effect of dilutive stock options	84,839	150,049	100,363	159,817
Weighted average shares of common stock and common stock equivalents	7,743,091	7,717,768	7,737,050	7,443,004
Net income per diluted share	\$ 0.07	\$ 0.13	\$ 0.24	\$ 0.40

During the three and nine month periods ended September 30, 2008, anti-dilutive weighted average options to purchase 260,304 and 244,728 shares of common stock, respectively, in prices ranging from \$7.00 to \$15.67 were outstanding. Anti-dilutive weighted average options of 181,794 and 192,610, respectively, were outstanding during the same three and nine month periods of 2007 with prices ranging from \$12.23 to \$15.67. They were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares. These options begin to expire in 2015.

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear elsewhere in this report.

Forward-Looking Statements

Some matters discussed in this Form 10-Q may be forward-looking statements within the meaning of the Private Litigation Reform Act of 1995 and therefore may involve risks, uncertainties and other factors which may cause our actual results to be materially different from the results expressed or implied by our forward-looking statements. These statements generally appear with words such as anticipate, believe, estimate, may, intend, and expect. Although management believes that the assumptions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions (both generally and in the markets where the Bank operates); competition from other providers of financial services offered by the Bank; government regulation and legislation; changes in interest rates; material unforeseen changes in the financial stability and liquidity of the Bank's credit customers; and other risks as may be detailed from time to time in the Company's filings with the Securities and Exchange Commission, all of which are difficult to predict and which may be beyond the control of the Company or the Bank. The Company undertakes no obligation to revise forward-looking statements to reflect events or changes after the date of this discussion or to reflect the occurrence of unanticipated events.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that effect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Allowance for Loan Losses

Accounting for allowance for loan losses involves significant judgment and assumptions by management and is based on historical data and management's view of the current economic environment. At least on a quarterly basis, our management reviews the methodology and adequacy of allowance for loan losses and reports its assessment to the Board of Directors for its review and approval.

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We base our allowance for loan losses on an estimation of probable losses inherent in our loan portfolio. Our methodology for assessing loan loss allowances are intended to reduce the differences between estimated and actual losses and involves a detailed analysis of our loan portfolio in three phases:

- the specific review of individual loans,
- the segmenting and review of loan pools with similar characteristics in accordance with SFAS No. 5, Accounting for Contingencies, and
- our judgmental estimate based on various subjective factors:

The first phase of our methodology involves the specific review of individual loans to identify and measure impairment. We evaluate each loan by use of a risk rating system, except for homogeneous loans, such as automobile loans and home mortgages. Specific risk rated loans are deemed impaired if all amounts, including principal and interest, will likely not be collected in accordance with the contractual terms of the related loan agreement. Impairment for commercial and real estate loans is measured either based on the present value of the loan's expected future cash flows or, if collection on the loan is collateral dependent, the estimated fair value of the collateral, less selling and holding costs.

The second phase involves the segmenting of the remainder of the risk rated loan portfolio into groups or pools of loans, together with loans with similar characteristics, for evaluation in accordance with SFAS No. 5. We determine the calculated loss ratio to each loan pool based on its historical net losses and benchmark it against the levels of other peer banks.

In the third phase, we consider relevant internal and external factors that may affect the collectibility of loan portfolio and each group of loan pool. The factors considered are, but are not limited to:

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- concentration of credits,

- nature and volume of the loan portfolio,

- delinquency trends,

- non-accrual loan trend,

- problem loan trend,

- loss and recovery trend,

- quality of loan review,

- lending and management staff,

- lending policies and procedures,

- economic and business conditions, and

- other external factors.

Our management estimates the probable effect of such conditions based on our judgment, experience and known or anticipated trends. Such estimation may be reflected as an additional allowance to each group of loans, if necessary. Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the

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evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance

Central to our credit risk management and our assessment of appropriate loss allowance is our loan risk rating system. Under this system, the originating credit officer assigns borrowers an initial risk rating based on a thorough analysis of each borrower's financial capacity in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior line and credit administration personnel. Credits are monitored by line and credit administration personnel for deterioration in a borrower's financial condition which may impact the ability of the borrower to perform under the contract. Although management has allocated a portion of the allowance to specific loans, specific loan pools, and off-balance sheet credit exposures (which are reported separately as part of other liabilities), the adequacy of the allowance is considered in its entirety.

Non-Accrual Loan Policy

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on nonaccrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals.

Stock-Based Compensation

Effective January 1, 2006, the Bank adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, *Share Based Payments*, a revision to the previously issued guidance on accounting for stock options and other forms of equity-based compensation. SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based forms of compensation issued to employees over the employees' requisite service period (generally the vesting period). The Bank has adopted SFAS No. 123R using the modified prospective method which means that the unvested portion of previously granted awards and any awards that are granted or modified after the date of adoption will be measured and accounted for under the provisions of SFAS No. 123R. Accordingly, financial statement amounts for prior periods have not been restated to reflect the fair value method of recognizing compensation cost relating to stock options. The Bank will continue to use straight-line recognition of expenses for awards with graded vesting. The Bank utilizes a binomial pricing model for all grants. Expected volatility is based on the historical volatility of the price of the Bank's stock. The Bank uses historical data to estimate option exercise and stock option forfeiture rates within the valuation model. The expected term of options granted for the binomial model is derived from applying a historical suboptimal exercise factor to the contractual term of the grant. For binomial pricing, the risk-free rate for periods is equal to the U.S. Treasury yield at the time of grant and commensurate with the contractual term of the grant.

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Other Real Estate Owned

Other real estate owned, which represents real estate acquired through foreclosure, or deed in lieu of foreclosure in satisfaction of commercial and real estate loans, is carried at the lower of cost or estimated fair value less the estimated selling costs of the real estate. The fair value of the property is based upon a current appraisal. The difference between the fair value of the real estate collateral and the loan balance at the time of transfer is recorded as a loan charge off if fair value is lower. Subsequent to foreclosure, management periodically performs valuations and the OREO property is carried at the lower of carrying value or fair value, less costs to sell. The determination of a property's estimated fair value incorporates (1) revenues projected to be realized from disposal of the property, (2) construction and renovation costs, (3) marketing and transaction costs, and (4) holding costs (e.g., property taxes, insurance and homeowners' association dues). Any subsequent declines in the fair value of the OREO property after the date of transfer are recorded through a write-down of the asset. Any subsequent operating expenses or income, reduction in estimated fair values, and gains or losses on disposition of such properties are charged or credited to current operations.

Introduction

Effective July 3, 2008, Oak Valley Community Bank became a subsidiary of Oak Valley Bancorp, a newly established bank holding company. Oak Valley Bancorp operates Oak Valley Community Bank as a community bank in the general commercial banking business, with our primary market encompassing the California Central Valley around Oakdale and Modesto, and the Eastern Sierras. As such, unless otherwise noted, all references are about Oak Valley Community Bank.

Overview of Results of Operations and Financial Condition

- The Company recognized net income of \$549,396 and \$1,877,930 for the three and nine month periods ended September 30, 2008 as compared with \$969,457 and \$2,974,238 for the same periods in 2007, respectively. The factors resulting in this decrease will be discussed below.
- Net interest income increased \$432,681 or 8.9% and \$1,067,521 or 7.6% for the three and nine month periods ended September 30, 2008, respectively, compared to the same periods in 2007. These increases were primarily due to increases in the net interest margin of 9 and 17 basis points and increases in average earning assets of \$27.8 million and \$13.4 million for the three and nine month periods ended September 30, 2008, respectively. The net interest margin increase is attributable primarily to liabilities repricing faster than assets in the current declining rate environment and a reduction of high cost certificates of deposit which were replaced by core deposits and FHLB advances with a lower interest rate.
- The provision for loan losses in the three and nine month periods ended September 30, 2008 increased by \$457,000 and \$752,000, respectively, compared to the same periods in 2007, due to loan growth, an increase in the level of non-accrual loans and management's assessment of the appropriate level for the allowance for loan losses.

- For the three and nine month periods ended September 30, 2008, non-interest income increased by \$138,320 or 27.9% and \$348,888 or 22.6%, respectively, from the same period in 2007, primarily due to increased service charges on deposits and earnings on cash surrender value of life insurance policies as described below.
- Non-interest expense increased by \$962,737 or 26.9% and \$2,825,837 or 27.4%, for the three and nine month periods ended September 30, 2008, respectively, as compared to the same periods in 2007, principally due to increased costs for salaries and benefits and OREO year-to-date expenses of \$936,370 due to overhead and market value write downs.
- Total assets increased \$35.9 million or 7.9% from December 31, 2007. Total net loans increased by \$28.8 million, or 7.5% from December 31, 2007 to September 30, 2008, while deposits decreased by \$12.1 million or 3.2%.

Income Summary

For the three and nine month periods ended September 30, 2008, the Company recorded net income of \$549,396 and \$1,877,930, a decrease of \$420,061 and \$1,096,308, respectively, as compared to the \$969,457 and \$2,974,238 in net income for the same periods in 2007. Return on average assets (annualized) was 0.45% and 0.54% for the third quarter and nine month period of 2008, respectively, as compared with 0.87% and 0.90% for the same periods of 2007. Annualized return on average equity was 4.91% and 5.72% for the third quarter and nine month period of 2008, respectively, as compared with 9.34% and 10.56% for the same periods of 2007.

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Earnings before provisions for income taxes for the third quarter and nine month period of 2008 were down \$848,736 and \$2,161,428, respectively from the comparable 2007 periods. The income statement components of these variances are as follows:

Pre-Tax Income Variance Summary

(In thousands)

	Effect on Pre-Tax Income Increase (Decrease) Three Months		Effect on Pre-Tax Income Increase (Decrease) Nine Months	
Change from 2007 to 2008 in:				
Net interest income	\$	433	\$	1,068
Provision for loan losses		(457)		(752)
Non-interest income		138		349
Non-interest expense		(963)		(2,826)
Change in income before income taxes	\$	(849)	\$	(2,161)

These variances will be explained in the discussion below.

Net Interest Income

Net interest income is the largest source of the Bank's operating income. For the three and nine month period ended September 30, 2008, net interest income was \$5.29 million and \$15.18 million, respectively, an increase of \$432,681 or 8.9% and \$1,067,521 or 7.6% from the comparable periods in 2007.

The net interest margin (net interest income as a percentage of average interest earning assets) was 4.76% and 4.71%, respectively, for the three and nine month periods ended September 30, 2008, an increase of 9 and 17 basis points as compared to the same periods in 2007. The increase in the net interest margin in 2008 was principally attributable to the change in the deposit mix from high cost certificates of deposit to lower cost core deposit accounts which caused the rate on interest-bearing liabilities to decrease faster than the rate on earning assets.

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The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company and the Bank on those assets and liabilities for the three and nine month periods ended September 30, 2008 and 2007:

Net Interest Analysis

(Dollars in thousands)

	Three Months Ended September 30, 2008			Three Months Ended September 30, 2007		
	Average Balance	Interest Inc / Exp	Avg Rate/ Yield	Average Balance	Interest Inc / Exp	Avg Rate/ Yield
Assets:						
Earning assets:						
Gross loans (1) (2)	\$ 408,476	\$ 7,047	6.84%	\$ 376,253	\$ 7,632	8.05%
Investment securities (2)	33,475	416	4.93%	34,666	433	4.96%
Federal funds sold	877	4	1.93%	4,268	55	5.07%
Interest-earning deposits	242	1	0.93%	77	1	4.28%
Total interest-earning assets	443,070	7,468	6.69%	415,264	8,121	7.76%
Total noninterest earning assets	39,090			28,340		
Total Assets	482,160			443,604		
Liabilities and Shareholders Equity:						
Interest-bearing liabilities:						
Money market deposits	153,260	927	2.40%	132,707	1,281	3.83%
NOW deposits	54,711	102	0.74%	53,262	150	1.12%
Savings deposits	15,225	47	1.23%	17,587	150	3.38%
Time certificates of deposit \$100,000 or more	33,177	280	3.34%	65,214	813	4.94%
Other time deposits	43,696	346	3.14%	49,482	593	4.76%
Other borrowings	73,900	455	2.45%	19,215	251	5.18%
Total interest-bearing liabilities	373,969	2,157	2.29%	337,466	3,238	3.81%
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	60,846			61,446		
Other liabilities	2,999			3,498		
Total noninterest-bearing liabilities	63,845			64,944		
Shareholders equity	44,346			41,194		
Total liabilities and shareholders equity	\$ 482,160			\$ 443,604		
Net interest income		\$ 5,311			\$ 4,883	
Net interest spread (3)			4.40%			3.95%
Net interest margin (4)			4.76%			4.67%

(1) Loan fees have been included in the calculation of interest income. Loan fees were approximately \$278,000 and \$381,000 for the three months ended September 30, 2008 and 2007, respectively. Loans are net of the allowance for loan losses, deferred fees, unearned income, and related direct costs.

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(2) Yields on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

(3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

(4) Represents net interest income as a percentage of average interest-earning assets.

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Net Interest Analysis

(Dollars in thousands)

	Nine Months Ended September 30, 2008			Nine Months Ended September 30, 2007		
	Average Balance	Interest Inc / Exp	Avg Rate/ Yield	Average Balance	Interest Inc / Exp	Avg Rate/ Yield
Assets:						
Earning assets:						
Gross loans (1) (2)	\$ 396,583	\$ 20,771	6.98%	\$ 379,156	\$ 22,799	8.04%
Investment securities (2)	33,964	1,244	4.88%	35,150	1,252	4.76%
Federal funds sold	780	14	2.36%	3,608	141	5.22%
Interest-earning deposits	146	2	1.45%	108	4	4.47%
Total interest-earning assets	431,473	22,031	6.80%	418,022	24,196	7.74%
Total noninterest earning assets	36,287			26,253		
Total Assets	467,760			444,275		
Liabilities and Shareholders Equity:						
Interest-bearing liabilities:						
Money market deposits	145,810	2,748	2.51%	122,787	3,405	3.71%
NOW deposits	54,994	298	0.72%	53,212	446	1.12%
Savings deposits	16,313	227	1.85%	16,897	432	3.42%
Time certificates of deposit \$100,000 or more	39,418	1,166	3.94%	68,205	2,528	4.95%
Other time deposits	42,209	1,130	3.57%	49,598	1,762	4.75%
Other borrowings	60,551	1,222	2.69%	36,198	1,427	5.27%
Total interest-bearing liabilities	359,295	6,791	2.52%	346,897	10,000	3.85%
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	61,556			56,149		
Other liabilities	3,127			3,554		
Total noninterest-bearing liabilities	64,683			59,703		
Shareholders equity	43,782			37,675		
Total liabilities and shareholders equity	\$ 467,760			\$ 444,275		
Net interest income		\$ 15,240			\$ 14,196	
Net interest spread(3)			4.28%			3.88%
Net interest margin(4)			4.71%			4.54%

(1) Loan fees have been included in the calculation of interest income. Loan fees were approximately \$828,000 and \$1,068,000 for the nine months ended September 30, 2008 and 2007, respectively. Loans are net of the allowance for loan losses, deferred fees, unearned income, and related direct costs.

(2) Yields on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

(3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

(4) Represents net interest income as a percentage of average interest-earning assets.

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Shown in the following tables are the relative impacts on net interest income of changes in the average outstanding balances (volume) of earning assets and interest bearing liabilities and the rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2008 and 2007. Changes in interest income and expense that are not attributable specifically to either rate or volume are allocated proportionately among both variances.

Rate / Volume Variance Analysis*(In thousands)*

	For the Three Months Ended September 30, 2008 vs 2007		
	Increase (Decrease) in interest income and expense due to changes in:		
	Volume	Rate	Total
Interest income:			
Gross loans (1)	\$ 653	\$ (1,238)	\$ (585)
Investment securities	(15)	(3)	(18)
Federal funds sold	(43)	(7)	(50)
Interest-earning deposits	2	(2)	(0)
Total interest income	\$ 597	\$ (1,250)	\$ (653)
Interest expense:			
Money market deposits	198	(553)	(355)
NOW deposits	4	(53)	(49)
Savings deposits	(20)	(83)	(103)
Time CD \$100K or more	(399)	(134)	(533)
Other time deposits	(69)	(178)	(248)
Other borrowings	715	(510)	205
Total interest expense	\$ 429	\$ (1,511)	\$ (1,082)
Change in net interest income	\$ 168	\$ 261	\$ 429

(1) Loan fees have been included in the calculation of interest income. Loan fees were approximately \$278,000 and \$381,000 for the three months ended September 30, 2008 and 2007, respectively. Loans are net of the allowance for loan losses, deferred fees, unearned income, and related direct costs.

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(in thousands)

	For the Nine Months Ended September 30, 2008 vs 2007		
	Increase (Decrease)		
	in interest income and expense		
	due to changes in:		
	Volume	Rate	Total
Interest income:			
Gross loans (1)	\$ 1,048	\$ (3,076)	\$ (2,028)
Investment securities	(42)	34	(8)
Federal funds sold	(110)	(17)	(127)
Interest-earning deposits	1	(3)	(2)
Total interest income	\$ 897	\$ (3,062)	\$ (2,165)
Interest expense:			
Money market deposits	\$ 638	(1,295)	(657)
NOW deposits	15	(163)	(148)
Savings deposits	(15)	(190)	(205)
Time CD \$100K or more	(1,067)	(295)	(1,361)
Other time deposits	(263)	(369)	(632)
Other borrowings	960	(1,165)	(205)
Total interest expense	\$ 268	\$ (3,477)	\$ (3,209)
Change in net interest income	\$ 629	\$ 415	\$ 1,044

(1) Loan fees have been included in the calculation of interest income. Loan fees were approximately \$828,000 and \$1,068,000 for the nine months ended September 30, 2008 and 2007, respectively. Loans are net of the allowance for loan losses, deferred fees, unearned income, and related direct costs.

The table above reflects the rates decline has impacted liabilities slightly more than assets as indicated by the increase of \$417,000 in net interest income due to the rate change. The increased loan volume and the overall change in mix of deposit balances contributed an increase of \$627,000 to net interest income.

Non-Interest Income

Non-interest income represents service charges on deposit accounts and other non-interest related charges and fees, including fees from the sale of loans. For the three and nine month period ended September 30, 2008, non-interest income was \$644,691 and \$1,930,643, an increase of \$139,001 or 27.5% and \$351,611 or 22.3%, respectively, from the same period in 2007.

The following table shows the major components of non-interest income:

Non-Interest Income

(In thousands)

Non-Interest Income

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2008	2007	\$ chg	% chg	2008	2007	\$ chg	% chg
Service charges on deposits	\$ 337	\$ 268	\$ 69	26.0%	\$ 985	\$ 808	\$ 177	21.9%
Earnings on cash surrender value of life insurance	99	44	55	127.5%	249	102	147	143.7%
Mortgage commissions	23	14	9	62.5%	95	167	(72)	(43.2)%
Other	175	171	4	2.4%	561	464	97	21.0%
	\$ 634	\$ 497	\$ 137	27.9%	\$ 1,890	\$ 1,541	\$ 349	22.6%

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Service charges on deposits increased by \$69,541 or 26.0% and \$176,703 or 21.9% in the three and nine month periods ended September 30, 2008, respectively, as compared to the same periods in 2007, which is primarily due to increases in the number of demand deposit accounts opened during the first nine months of 2008. The Bank continues to expand its offerings to the consumer and business depositor. Currently, the Bank is pursuing a strategy to increase its core deposit base further by expanding the Bank's offering of remote deposit capture products as well as cash management products for current and prospective business depositors. In addition, Earnings on cash surrender of life insurance increased by \$55,626 and 146,872 as a result of the \$4.74 million invested in additional life insurance policies on certain officers and directors during the first quarter of 2008.

Non-Interest Expense

Non-interest expense represents salaries and benefits, occupancy expenses, professional expenses, outside services, and other miscellaneous expenses necessary to conduct business.

The following table shows the major components of non-interest expenses:

Non-Interest Expense

(In thousands)

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2008	2007	\$ change	% change	2008	2007	\$ change	% change
Salaries and employee benefits	\$ 2,319	\$ 2,121	\$ 198	9.3%	\$ 7,201	\$ 6,274	\$ 927	14.8%
Occupancy expenses	676	603	73	12.0%	2,016	1,657	359	21.7%
Data processing fees	193	169	24	14.2%	562	385	177	45.9%
Telephone expenses	74	64	10	15.8%	219	188	31	16.2%
OREO expenses	485		485		936		936	
Other operating expenses	788	615	173	28.2%	2,189	1,793	396	22.1%
	\$ 4,535	\$ 3,572	\$ 963	26.9%	\$ 13,123	\$ 10,297	\$ 2,826	27.4%

Non-interest expenses increased by \$962,737 or 26.9% and \$2,825,837 or 27.4% for the three and nine months ended September 30, 2008, as compared to the same periods of 2007. Salaries and employee benefits increased \$198,063 and \$926,384 for the three and nine months ended September 30, 2008, as compared to the same periods of 2007 as a result of additional facilities, in Stockton and Oakdale, and corresponding branch personnel, as well as continued additions to the Bank's administrative and support personnel, positioning the Bank for continued growth. These additional facilities were the primary reason for the increase in occupancy expense of \$72,245 and \$359,011 for the three and nine months ended September 30, 2008, as compared to the same periods of 2007.

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Management anticipates that noninterest expense will continue to increase as we continue to grow. However, management remains committed to cost-control and efficiency, and we expect to keep these increases to a minimum relative to growth.

Income Taxes

Income tax expense for the three and nine months ended September 30, 2008, was \$239,595 and \$883,150, respectively, a decrease of \$428,675 or 64.1% and \$1,065,120 or 54.7% for the same periods in 2007. The effective tax rate (income tax expense as a percentage of pre-tax income) for the third quarter and nine month period of 2008 was 30.4% and 32.0%, respectively, compared with 40.8% and 39.6% for the same period in 2007. The disparity between the effective tax rates in 2008 as compared to 2007 is primarily due to tax credits from California Enterprise Zones and low income housing projects as well as tax free-income on loans within these enterprise zones and municipal securities and loans that comprise a larger proportion of pre-tax income in 2008 as compared to 2007.

Balance Sheet Analysis

At September 30, 2008, consolidated assets totaled \$490.1 million, as compared with \$454.3 million at December 31, 2007. This represents an increase of \$35.8 million or 7.9% compared to December 31, 2007. Total net loans increased \$28.8 million or 7.5% over that period, while deposits decreased \$12.1 million or 3.2% and shareholders equity increased \$1.8 million or 4.2% over that same period.

Table of Contents**Asset Quality**

Nonperforming assets consist of loans on non-accrual status, loans 90 days or more past due and still accruing interest, loans restructured, where the terms of repayment have been renegotiated resulting in a reduction or deferral of interest or principal, and other real estate owned (OREO).

Loans are generally placed on non-accrual status when they become 90 days past due, unless management believes the loan is adequately collateralized and in the process of collection. The past due loans may or may not be adequately collateralized, but collection efforts are continuously pursued. Loans may be restructured by management when a borrower has experienced some changes in financial status, causing an inability to meet the original repayment terms, and where we believe the borrower will eventually overcome those circumstances and repay the loan in full. OREO consists of properties acquired by foreclosure or similar means and which management intends to offer for sale.

Non-accrual loans totaled \$2.17 million at September 30, 2008, as compared to \$9.09 million at December 31, 2007. The non-accrual loans as of September 30, 2008 are loans made to 4 borrowers for purposes of residential construction and commercial real estate.

OREO totals \$4.36 million as of September 30, 2008 and consists of three properties that were acquired through foreclosure including residential land lots and a commercial real estate property.

The following table presents information about the Company's non-performing loans, including asset quality ratios as of September 30, 2008 and December 31, 2007:

Non-Performing Assets

(in thousands)

	September 30 2008	December 31 2007
Loans in nonaccrual status	\$ 2,175	\$ 9,087
Loans past due 90 days or more and accruing		721
Restructured loans		
Total nonperforming loans	2,175	9,808
Other real estate owned	4,365	
Total nonperforming assets	\$ 6,540	\$ 9,808
Allowance for loan losses	\$ 4,650	\$ 4,507
Asset quality ratios:		
Non-performing assets to total assets	1.33%	2.16%
Non-performing loans to total loans	0.52%	2.54%
Allowance for loan losses to total loans	1.12%	1.16%

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Allowance for loan losses to total non-performing loans	214%	46%
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Table of Contents**Allowance for Loan and Lease Losses**

In anticipation of credit risk inherent in our lending business, we set aside allowances through charges to earnings. Such charges were not only made for the outstanding loan portfolio, but also for off-balance sheet items, such as commitments to extend credits or letters of credit. The charges made for the outstanding loan portfolio were credited to the allowance for loan losses, whereas charges for off-balance sheet items were credited to the reserve for off-balance sheet items, which is presented as a component of other liabilities. The Bank recorded loan loss provisions of \$602,000 and \$1,187,000 for the three and nine month periods in 2008, respectively, a \$457,000 and \$752,000 increase from the provisions recorded in the same periods of 2007.

The allowance for loan losses increased by 3.2%, or \$142,970, to \$4.65 million at September 30, 2008, as compared with \$4.51 million at December 31, 2007. The Bank recognized the increase in the allowance for loan losses during the first nine months of the year due to the loan loss provision of \$1.19 million which was partially offset by loan chargeoffs. The weak business climate adversely impacted the financial conditions of certain clients and increased net loan charge-offs by \$1.03 million, for the first nine months of 2008, compared to \$30,000 for the first nine months of 2007. The increase to the allowance for loan losses was outpaced by the growth of our loan portfolio which decreased the allowance for loan losses as a percentage of total loans to 1.12% at September 30, 2008 as compared to 1.16% at December 31, 2007.

Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance. Although management has allocated a portion of the allowance to specific loan categories, the adequacy of the allowance is considered in its entirety.

The following table provides an analysis of the changes in the ALLL for the nine-month periods ended September 30, 2008 and 2007:

Allowance for Loan and Lease Losses

(dollars in thousands)

		Nine Months Ended September 30,		
	2008		2007	
Balance at beginning of period	\$	4,507	\$	4,341
Provision for loan losses		1,187		435
Loans charged off		(1,032)		(32)
Recoveries of previous charge-offs		4		3
Net charge-offs		(1,029)		(29)
Reclassification of reserve related to off-balance-sheet commitments		(16)		10
Balance at end of period	\$	4,650	\$	4,757

Allowance for loan losses as a percentage of:

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Period end loans	1.12%	1.23%
Non-performing loans	213.74%	391.29%
As a percentage of average loans (annualized):		
Net charge-offs	.35%	.01%
Provision for loan losses	.40%	.15%

The Bank makes provisions for loan losses when required to bring the total allowance for loan and lease losses to a level deemed appropriate for the level of risk in the loan portfolio. At least quarterly, management conducts an assessment of the overall quality of the loan portfolio and general economic trends in the local market. The determination of the appropriate level for the allowance is based on that review, considering such factors as historical experience, the volume and type of lending conducted, the amount of and identified potential loss associated with specific nonperforming loans, regulatory policies, general economic conditions, and other factors related to the collectibility of loans in the portfolio.

Although management believes the allowance at September 30, 2008 was adequate to absorb probable losses from any known and inherent risks in the portfolio, no assurance can be given that economic conditions which adversely affect our service areas or other variables will not result in increased losses in the loan portfolio in the future.

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Investment Activities

Investments are a key source of interest income. Management of our investment portfolio is set in accordance with strategies developed and overseen by our Investment Committee. Investment balances, including cash equivalents and interest-bearing deposits in other financial institutions, are subject to change over time based on our asset/liability funding needs and interest rate risk management objectives. Our liquidity levels take into consideration anticipated future cash flows and all available sources of credits and are maintained at levels management believes are appropriate to assure future flexibility in meeting anticipated funding needs.

Cash Equivalents and Interest-bearing Deposits in other Financial Institutions

The Bank holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of September 30, 2008, and December 31, 2007, we had \$10.64 million, and \$14.20 million, respectively, in cash and cash equivalents.

Investment Securities

Management of our investment securities portfolio focuses on providing an adequate level of liquidity and establishing an interest rate-sensitive position, while earning an adequate level of investment income without taking undue risk. Investment securities that we intend to hold until maturity are classified as held-to-maturity securities, and all other investment securities are classified as available-for-sale. Currently, all of our investment securities are classified as available-for-sale. The carrying values of available-for-sale investment securities are adjusted for unrealized gains or losses as a valuation allowance and any gain or loss is reported on an after-tax basis as a component of other comprehensive income.

Management has evaluated the investment securities portfolio to determine if the impairment of any security in an unrealized loss position is temporary or other than temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes.

Deposits

Total deposits at September 30, 2008 were \$365.2 million, a \$12.1 million or 3.2% decrease from the deposit total of \$377.3 million at December 31, 2007. Average deposits decreased \$6.5 to \$360.3 million for the nine month period ended September 30, 2008 as compared to the same period in 2007.

Deposits

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(in thousands)

	September 30, 2008	December 31, 2007	Nine months change	
	\$	\$	\$	%
Demand	\$ 58,292	\$ 68,151	\$ (9,859)	(14.5)%
NOW	53,831	54,496	(666)	(1.2)%
MMDA	157,215	138,414	18,801	13.6%
Savings	14,411	16,438	(2,027)	(12.3)%
Time < 100K	45,419	42,228	3,192	7.6%
Time > \$100K	36,062	57,621	(21,559)	(37.4)%
	\$ 365,230	\$ 377,348	\$ (12,118)	(3.2)%

Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. A number of clients carry deposit balances of more than 1% of our total deposits, but only one customer had a deposit balance of more than 3% of total deposits at September 30, 2008.

Since our deposit growth strategy emphasizes core deposit growth we have avoided relying on brokered deposits as a consistent source of funds. The only brokered deposit the Bank holds are from CDARS, a certificate of deposit program that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer. The bank had \$4.2 million in brokered deposits as of September 30, 2008 and none at December 31, 2007.

Table of Contents**Borrowings**

Although deposits are the primary source of funds for our lending and investment activities and for general business purposes, we may obtain advances from the Federal Home Loan Bank of San Francisco (FHLB) as an alternative to retail deposit funds. Our outstanding FHLB advances increased by \$47 million at September 30, 2008, to \$78.0 million, compared to \$31.0 million at December 31, 2007 due to the decrease in deposits. See Liquidity Management below for the details on the FHLB borrowings program.

Capital Ratios

We are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can trigger regulatory actions that could have a material adverse effect on our financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that rely on quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The following table shows the Oak Valley Community Bank's capital ratios, as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to qualify as a well-capitalized institution at September 30, 2008, December 31, 2007:

Oak Valley Community Bank Capital Ratios

(dollars in thousands)

	Actual		Amount of Capital Required			
	Amount	Ratio	To Be Well-Capitalized Amount	To Be Well-Capitalized Ratio	To Be Adequately Capitalized Amount	To Be Adequately Capitalized Ratio
As of September 30, 2008:						
Total Capital (to Risk-Weighted Assets)	\$ 48,880	10.60%	\$ 46,109	10%	\$ 36,887	8%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 44,049	9.55%	\$ 27,665	6%	\$ 18,444	4%
Tier 1 Capital (to Average Assets)	\$ 44,049	9.14%	\$ 24,108	5%	\$ 19,286	4%
As of December 31, 2007:						
Total Capital (to Risk-Weighted Assets)	\$ 47,311	11.13%	\$ 42,493	10%	\$ 33,994	8%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 42,594	10.02%	\$ 25,496	6%	\$ 16,997	4%
Tier 1 Capital (to Average Assets)	\$ 42,594	9.42%	\$ 22,614	5%	\$ 18,092	4%

Liquidity Management

Maintenance of adequate liquidity requires that sufficient resources be available at all time to meet our cash flow requirements. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of its customers and to take advantage of investment opportunities as they arise. Liquidity management involves our ability to convert assets into cash or cash equivalents without incurring significant loss, and to raise cash or maintain funds without incurring excessive additional cost. For this purpose, we maintain a portion of our funds in cash and cash equivalents, salable government guaranteed loans and securities available for sale. Our liquid assets at September 30, 2008 was \$53.2 million compared to \$59.9 million at December 31, 2007. Our liquidity level measured as the percentage of liquid assets to total assets was 10.9% and 13.2% at September 30, 2008 and December 31, 2007, respectively.

As a secondary source of liquidity, we rely on advances from the FHLB to supplement our supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are typically secured by a portion of our loan portfolio. The FHLB determines limitations on the amount of advances by assigning a percentage to each eligible loan category that will count towards the borrowing capacity. As of September 30, 2008, our borrowing capacity from the FHLB was approximately \$101 million and the

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outstanding balance was \$78 million, or approximately 77% of our borrowing capacity. We also maintain 2 lines of credit with correspondent banks to purchase up to \$20 million in federal funds, for which there were no advances as of September 30, 2008.

Off-Balance-Sheet Arrangements

During the ordinary course of business, we provide various forms of credit lines to meet the financing needs of our customers. These commitments, which represent a credit risk to us, are not represented in any form on our balance sheets.

As of September 30, 2008 and December 31, 2007, we had commitments to extend credit of \$67.1 million and \$81.40 million, respectively, which includes obligations under letters of credit of \$2.68 million and \$1.14 million, respectively,

The effect on our revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

Effects of Inflation and Economic Issues

Inflation primarily impacts us by its effect on interest rates. Our primary source of income is net interest income, which is affected by changes in interest rates. We attempt to limit the impact of inflation on our net interest margin through management of rate-sensitive assets and liabilities and the analysis of interest rate sensitivity. The effect of inflation on premises and equipment as well as noninterest expenses has not been significant for the periods covered in this report. Our business is generally not seasonal.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4T. 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 13a-15(e) and 15(d)-15(e) promulgated under the Exchange Act, 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 would be made known to them by others within the Company, particularly during the period in which this 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 recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file 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.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect the Company's internal controls over financial reporting in the first nine months of 2008.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

There are no material legal proceedings to which the Company is a party or to which any of its property is subject.

Item 1A. Risk Factors

Not applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On July 3, 2008, in connection with the bank holding company reorganization between Oak Valley Community Bank, Oak Valley Bancorp issued 7,658,252 shares of its common stock to the shareholders of Oak Valley Community Bank pursuant to an exemption under Section 3(a)(12) of the 1933 Securities Act, as amended.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6.

Exhibits

Exhibit	Description
31.01	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
31.02	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
32.01	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 13, 2008

Oak Valley Bancorp
By:

/s/ RICHARD A. MCCARTY
Richard A. McCarty
Executive Vice President and Chief Financial
Officer
(Principal Financial Officer and duly authorized
signatory)

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EXHIBIT INDEX

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