

FIRST NORTHERN COMMUNITY BANCORP  
Form 10-Q  
November 06, 2014

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

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FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2014

OR

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 000-30707

First Northern Community Bancorp  
(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization) 68-0450397  
(I.R.S. Employer Identification Number)

195 N. First Street, Dixon, California  
(Address of principal executive offices) 95620  
(Zip Code)

707-678-3041  
(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 Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Yes  No

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

The number of shares of Common Stock outstanding as of November 3, 2014 was 9,800,456.

FIRST NORTHERN COMMUNITY BANCORP

INDEX

PART I – Financial Information

ITEM 1. – Financial Statements (Unaudited) .....

Condensed Consolidated Balance Sheets (Unaudited) .....

Condensed Consolidated Statements of Income (Unaudited) .....

Condensed Consolidated Statements of Comprehensive Income (Unaudited) .....

Condensed Consolidated Statement of Stockholders' Equity (Unaudited) .....

Condensed Consolidated Statements of Cash Flows (Unaudited) .....

Notes to Condensed Consolidated Financial Statements .....

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

ITEM 3. – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK .....

ITEM 4. – CONTROLS AND PROCEDURES .....

PART II – OTHER INFORMATION .....

ITEM 1. – LEGAL PROCEEDINGS .....

ITEM 1A. – RISK FACTORS .....

ITEM 2. – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS .....

ITEM 3. – DEFAULTS UPON SENIOR SECURITIES .....

ITEM 4. – MINE SAFETY DISCLOSURES .....

ITEM 5. – OTHER INFORMATION .....

ITEM 6. – EXHIBITS .....

SIGNATURES .....

## PART I – FINANCIAL INFORMATION

## FIRST NORTHERN COMMUNITY BANCORP

## ITEM I. – FINANCIAL STATEMENTS (UNAUDITED)

## CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

| (in thousands, except shares and share amounts)  | September<br>30,<br>2014 | December<br>31,<br>2013 |
|--|--------------------------|-------------------------|
| Assets   |                          |                         |
| Cash and cash equivalents  | \$246,628                | \$177,254               |
| Investment securities – available-for-sale   | 143,789                  | 173,269                 |
| Loans, net of allowance for loan losses of \$8,402 at September 30, 2014<br>and \$9,353 at December 31, 2013   | 524,796                  | 506,850                 |
| Loans held-for-sale  | 1,258                    | 1,263                   |
| Stock in Federal Home Loan Bank and other equity securities, at cost   | 3,934                    | 3,717                   |
| Premises and equipment, net  | 7,296                    | 7,418                   |
| Interest receivable and other assets   | 26,354                   | 27,898                  |
| Total Assets   | \$954,055                | \$897,669               |
| Liabilities and Stockholders' Equity   |                          |                         |
| Liabilities:   |                          |                         |
| Demand deposits  | \$274,249                | \$274,831               |
| Interest-bearing transaction deposits  | 218,602                  | 207,879                 |
| Savings and MMDA's   | 273,030                  | 231,491                 |
| Time, under \$100,000  | 32,116                   | 33,467                  |
| Time, \$100,000 and over   | 57,781                   | 56,119                  |
| Total deposits   | 855,778                  | 803,787                 |
| Interest payable and other liabilities   | 8,011                    | 8,974                   |
| Total Liabilities  | 863,789                  | 812,761                 |
| Stockholders' Equity:  |                          |                         |
| Preferred stock, no par value; \$1,000 per share liquidation preference,<br>22,847 shares authorized; 12,847 shares issued and outstanding at September 30, 2014<br>and December 31, 2013      | 12,847                   | 12,847                  |
| Common stock, no par value; 16,000,000 shares authorized;<br>9,800,456 shares issued and outstanding at September 30, 2014 and 9,495,674 shares<br>issued and outstanding at December 31, 2013 | 66,788                   | 64,584                  |

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|  |           |           |
|--|-----------|-----------|
| Additional paid-in capital                 | 977       | 977       |
| Retained earnings                          | 9,678     | 7,573     |
| Accumulated other comprehensive loss, net  | (24 )     | (1,073 )  |
| Total Stockholders' Equity                 | 90,266    | 84,908    |
| Total Liabilities and Stockholders' Equity | \$954,055 | \$897,669 |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

| (in thousands, except per share amounts)                   | Three<br>months<br>ended<br>September<br>30, 2014 | Three<br>months<br>ended<br>September<br>30, 2013 | Nine<br>months<br>ended<br>September<br>30, 2014 | Nine<br>months<br>ended<br>September<br>30, 2013 |
|--|---|---|--|--|
| Interest and dividend income:                              |   |   |  |  |
| Loans  | \$6,717   | \$6,466   | \$19,795   | \$18,671   |
| Due from banks interest bearing accounts                   | 132   | 103   | 411  | 315  |
| Investment securities                                      |   |   |  |  |
| Taxable  | 741   | 621   | 2,232  | 1,961  |
| Non-taxable  | 85  | 99  | 282  | 298  |
| Other earning assets                                       | 77  | 46  | 205  | 106  |
| Total interest and dividend income                         | 7,752   | 7,335   | 22,925   | 21,351   |
| Interest expense:  |   |   |  |  |
| Deposits   | 312   | 306   | 973  | 952  |
| Total interest expense                                     | 312   | 306   | 973  | 952  |
| Net interest income  | 7,440   | 7,029   | 21,952   | 20,399   |
| Provision for loan losses                                  | 400   | —   | 1,600  | 800  |
| Net interest income after provision<br>for loan losses     | 7,040   | 7,029   | 20,352   | 19,599   |
| Other operating income:                                    |   |   |  |  |
| Service charges on deposit accounts                        | 599   | 606   | 1,689  | 1,876  |
| Gains on sales of other real estate owned                  | —   | —   | —  | 1  |
| Gains on sales of loans held-for-sale                      | 179   | 129   | 456  | 1,121  |
| Investment and brokerage services income                   | 158   | 295   | 479  | 958  |
| Mortgage brokerage income                                  | 9   | 28  | 15   | 63   |
| Loan servicing income                                      | 145   | 490   | 366  | 1,203  |
| Fiduciary activities income                                | 121   | 136   | 457  | 465  |
| ATM fees   | 145   | 67  | 335  | 219  |
| Signature based transaction fees                           | 487   | 337   | 1,183  | 966  |
| Gains on calls of available-for-sale securities            | 53  | —   | 53   | 4  |
| Other income   | 208   | 185   | 647  | 567  |
| Total other operating income                               | 2,104   | 2,273   | 5,680  | 7,443  |
| Other operating expenses:                                  |   |   |  |  |
| Salaries and employee benefits                             | 4,031   | 4,422   | 11,556   | 12,630   |
| Occupancy and equipment                                    | 728   | 757   | 2,186  | 2,289  |
| Data processing  | 434   | 414   | 1,265  | 1,258  |
| Stationery and supplies                                    | 81  | 92  | 255  | 281  |
| Advertising  | 84  | 76  | 257  | 263  |
| Directors' fees  | 68  | 54  | 190  | 161  |
| Other real estate owned expense (income) and<br>impairment | 65  | (10)  | 106  | 11   |

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|   |         |          |         |          |
|---|---------|----------|---------|----------|
| Impairment on other interest earning asset  | —       | —        | 50      | —        |
| Other expense                               | 1,301   | 1,120    | 3,880   | 3,637    |
| Total other operating expenses              | 6,792   | 6,925    | 19,745  | 20,530   |
| Income before provision for income taxes    | 2,352   | 2,377    | 6,287   | 6,512    |
| Provision for income taxes                  | 782     | 1,004    | 2,014   | 2,334    |
| Net income                                  | \$1,570 | \$1,373  | \$4,273 | \$4,178  |
| Preferred stock dividends                   | \$(33 ) | \$(162 ) | \$(97 ) | \$(534 ) |
| Net income available to common shareholders | \$1,537 | \$1,211  | \$4,176 | \$3,644  |
| Basic earnings per share                    | \$0.16  | \$0.12   | \$0.43  | \$0.38   |
| Diluted earnings per share                  | \$0.16  | \$0.12   | \$0.43  | \$0.37   |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

| (in thousands)  | Three<br>months<br>ended<br>September<br>30,<br>2014 | Three<br>months<br>ended<br>September<br>30,<br>2013 | Nine<br>months<br>ended<br>September<br>30,<br>2014 | Nine<br>months<br>ended<br>September<br>30,<br>2013 |
|---|--|--|---|---|
| Net income  | \$1,570  | \$1,373  | \$4,273   | \$4,178   |
| Other comprehensive income (loss), net of tax:  |  |  |   |   |
| Unrealized holding gains (losses) on securities:  |  |  |   |   |
| Unrealized holding gains (losses) arising during the period,<br>net of tax effect of \$(131) and \$93 for the three-month<br>periods ended September 30, 2014 and September 30, 2013,<br>respectively, and \$721 and \$(1,539) for the nine-month<br>periods ended September 30, 2014 and September 30, 2013,<br>respectively | (196 )   | 139  | 1,081   | (2,309 )  |
| Less: reclassification adjustment due to gains realized on<br>sales of securities, net of tax effect of \$(21) and \$0 for the<br>three-month periods ended September 30, 2014 and<br>September 30, 2013, and \$(21) and \$(2) for the nine-month<br>periods ended September 30, 2014 and September 30, 2013,<br>respectively | (32 )  | —  | (32 )   | (2 )  |
| Other comprehensive (loss) income   | \$(228 )   | \$139  | \$1,049   | \$(2,311 )  |
| Comprehensive income  | \$1,342  | \$1,512  | \$5,322   | \$1,867   |

See notes to unaudited condensed consolidated financial statements.



## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)

(in thousands, except share data)

|   | Preferred Stock |          | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total    |
|---|-----------------|----------|--------------|----------|----------------------------------|----------------------|---|----------|
|   | Shares          | Amounts  | Shares       | Amounts  |                                  |                      |   |          |
| Balance at<br>December 31, 2013                                       | 12,847          | \$12,847 | 9,495,674    | \$64,584 | \$ 977                           | \$7,573              | \$ (1,073 )   | \$84,908 |
| Net income  |                 |          |              |          |                                  | 4,273                |   | 4,273    |
| Other<br>comprehensive<br>income                                      |                 |          |              |          |                                  |                      | 1,049   | 1,049    |
| 3% stock dividend   |                 |          | 284,871      | 2,065    |                                  | (2,065 )             |   | —        |
| Dividend on<br>preferred stock  |                 |          |              |          |                                  | (97 )                |   | (97 )    |
| Cash in lieu of<br>fractional shares                                  |                 |          | (145 )       |          |                                  | (6 )                 |   | (6 )     |
| Stock-based<br>compensation and<br>related tax benefit                |                 |          |              | 139      |                                  |                      |   | 139      |
| Common shares<br>issued related to<br>restricted stock<br>grants, net |                 |          | 24,166       |          |                                  |                      |   | —        |
| Restricted stock<br>forfeited   |                 |          | (4,110 )     |          |                                  |                      |   | —        |
| Balance at<br>September 30, 2014                                      | 12,847          | \$12,847 | 9,800,456    | \$66,788 | \$ 977                           | \$9,678              | \$ (24 )  | \$90,266 |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

|  | (in thousands)                                   |   |
|--|--|---|
|  | Nine<br>months<br>ended<br>September 30,<br>2014 | Nine months<br>ended<br>September 30,<br>2013 |
| <b>Cash Flows From Operating Activities</b>  |  |   |
| Net income   | \$4,273  | \$ 4,178                                      |
| Adjustments to reconcile net income to net cash provided by operating activities:    |  |   |
| Depreciation   | 504  | 526   |
| Accretion and amortization of investment securities premiums and discounts, net      | 1,554  | 2,656   |
| Valuation adjustment on mortgage servicing rights                                    | —  | (536 )  |
| Decrease in deferred loan origination fees and costs, net                            | (139 )   | (313 )  |
| Provision for loan losses  | 1,600  | 800   |
| Stock plan accruals  | 139  | 109   |
| Gains on calls/sales of available-for-sale securities                                | (53 )  | (4 )  |
| Impairment on other interest earning assets  | 50   | —   |
| Gains on sales of other real estate owned  | —  | (1 )  |
| Impairment on other real estate owned  | 48   | 10  |
| Gains on sales of loans held-for-sale  | (456 )   | (1,121 )                                      |
| Proceeds from sales of loans held-for-sale   | 21,309   | 61,014  |
| Originations of loans held-for-sale  | (20,848 )  | (57,125 )                                     |
| Changes in assets and liabilities:   |  |   |
| Decrease in interest receivable and other assets                                     | 844  | 1,302   |
| Net (decrease) increase in interest payable and other liabilities                    | (963 )   | 502   |
| Net cash provided by operating activities  | 7,862  | 11,997  |
| <b>Cash Flows From Investing Activities</b>  |  |   |
| Proceeds from maturities of available-for-sale securities                            | 14,362   | 8,025   |
| Proceeds from sales of available-for-sale securities                                 | 12,140   | —   |
| Principal repayments on available-for-sale securities                                | 16,070   | 27,368  |
| Purchase of available-for-sale securities  | (12,844 )  | (44,413 )                                     |
| Net increase in loans  | (19,869 )  | (56,754 )                                     |
| Net increase in stock in Federal Home Loan Bank and other equity securities, at cost | (267 )   | (110 )  |
| Proceeds from sale of other real estate owned  | 414  | 513   |
| Purchases of premises and equipment, net   | (382 )   | (206 )  |
| Net cash provided by (used in) investing activities                                  | 9,624  | (65,577 )                                     |
| <b>Cash Flows From Financing Activities</b>  |  |   |
| Net increase in deposits   | 51,991   | 52,703  |

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|   |           |             |
|---|-----------|-------------|
| Redemption of preferred stock   | —         | (10,000 )   |
| Cash dividends paid in lieu of fractional shares                                    | (6 )      | (4 )        |
| Cash dividends paid on preferred stock  | (97 )     | (534 )      |
| Net cash provided by financing activities   | 51,888    | 42,165      |
| Net increase (decrease) in Cash and Cash Equivalents                                | 69,374    | (11,415 )   |
| Cash and Cash Equivalents, beginning of period                                      | 177,254   | 161,359     |
| Cash and Cash Equivalents, end of period  | \$246,628 | \$ 149,944  |
| Supplemental Disclosures of Cash Flow Information:                                  |           |             |
| Cash paid during the period for:  |           |             |
| Interest  | \$958     | \$ 962      |
| Income Taxes  | \$1,213   | \$ 1,260    |
| Supplemental disclosures of non-cash investing and financing activities:            |           |             |
| Stock dividend distributed  | \$2,065   | \$ 1,047    |
| Tax deficiency related to expired, vested non-qualified stock options               | \$—       | \$ (106 )   |
| Financed sale of other real estate owned  | \$—       | \$ (540 )   |
| Transfer of loans held-for-investment to other real estate owned                    | \$462     | \$ —        |
| Unrealized holding gains (losses) on available for sale securities,<br>net of taxes | \$1,049   | \$ (2,311 ) |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014 and 2013 and December 31, 2013

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of First Northern Community Bancorp (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Articles 9 and 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for any interim period are not necessarily indicative of results expected for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission. The preparation of financial statements in conformity with GAAP also requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. All material intercompany balances and transactions have been eliminated in consolidation.

Recently Issued Accounting Pronouncements:

In February 2013, FASB issued ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date, which provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. Examples of obligations within the scope of this guidance include debt arrangements, other contractual obligations, and settled litigation and judicial rulings. This guidance is effective for interim and annual periods beginning on January 1, 2014 and must be retroactively applied to prior periods presented. Early adoption is permitted. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements.

In July 2013, FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The amendments in this ASU provide that an unrecognized tax benefit, or a portion thereof, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption and retrospective application is permitted. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements.

In January 2014, FASB issued ASU 2014-01, Investments – Equity Method and Joint Ventures. The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Disclosures for a change in accounting principle are required upon transition. The amendments should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In January 2014, FASB issued ASU 2014-04, *Receivables – Troubled Debt Restructurings by Creditors*. The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this ASU using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In January, 2014, FASB issued ASU 2014-05, *Service Concession Arrangements*. The amendments specify that an operating entity should not account for a service concession arrangement that is within the scope of this ASU as a lease in accordance with Topic 840. An operating entity should refer to other Topics as applicable to account for various aspects of a service concession arrangement. The amendments also specify that the infrastructure used in a service concession arrangement should not be recognized as property, plant, and equipment of the operating entity. The amendments in this ASU should be applied on a modified retrospective basis to service concession arrangements that exist at the beginning of an entity's fiscal year of adoption. The modified retrospective approach requires the cumulative effect of applying this ASU to arrangements existing at the beginning of the period of adoption to be recognized as an adjustment to the opening retained earnings balance for the annual period of adoption. The amendments are effective for a public business entity for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In August, 2014, FASB issued ASU 2014-14, *Receivables- Troubled Debt Restructuring by Creditors: Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*. The amendment affects creditors that hold government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA. It requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are present:

- The loan has a government guarantee that is not separable from the loan before foreclosure.
- At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim.
- At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments are effective for a public business entity for annual periods and interim periods within those annual periods, beginning after December 15, 2014.

In August, 2014, FASB issued ASU 2014-15, Presentation of Financial Statements- Going Concern: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The amendment defines management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. Under GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities. Currently, GAAP lacks guidance about management's responsibility to evaluate whether there is substantial doubt about the organization's ability to continue as a going concern or to provide related footnote disclosures. This ASU provides guidance to an organization's management, with principles and definitions that are intended to reduce diversity in the timing and content of disclosures that are commonly provided by organizations today in the financial statement footnotes. The amendments are effective for a public business entity for annual periods ending after December 15, 2016, and interim periods within those annual periods, beginning after December 15, 2016. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

#### Reclassifications

Certain reclassifications have been made to prior period balances in order to conform to the current year presentation.

## 2. LOANS

The composition of the Company's loan portfolio, by loan class, is as follows:

| (\$ in thousands)                       | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| Commercial                              | \$117,241                | \$110,644               |
| Commercial Real Estate                  | 253,960                  | 235,296                 |
| Agriculture                             | 55,293                   | 51,730                  |
| Residential Mortgage                    | 49,471                   | 52,809                  |
| Residential Construction                | 5,395                    | 10,444                  |
| Consumer                                | 50,498                   | 54,079                  |
|   | 531,858                  | 515,002                 |
| Allowance for loan losses               | (8,402 )                 | (9,353 )                |
| Net deferred origination fees and costs | 1,340                    | 1,201                   |
| Loans, net                              | \$524,796                | \$506,850               |

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies.

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and real property of the business and are susceptible to the related risks described above. Problem commercial loans are generally identified by periodic review of financial information that may include financial statements, tax returns, and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate means.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner-occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment, receivables or other personal property or unsecured. Losses on loans secured by owner-occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default



is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or payments for services. Agricultural loans are generally secured by inventory, receivables, equipment, and real property. Agricultural loans are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as adverse weather conditions, including drought conditions such as those affecting California. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary.

Residential mortgage loans, which are secured by real estate, are primarily susceptible to four risks: non-payment due to diminished or lost income; over-extension of credit; a lack of borrower's cash flow to sustain payments; and shortfalls in collateral value. In general, non-payment is usually due to loss of employment and follows general economic trends in the economy, particularly the upward movement in the unemployment rate, loss of collateral value, and demand shifts.

Residential construction loans, whether owner-occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction, including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, or repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate means.

Consumer loans, whether unsecured or secured are primarily susceptible to four risks: non-payment due to diminished or lost income; over-extension of credit; a lack of borrower's cash flow to sustain payments; and shortfall in the collateral value. In general, non-payment is usually due to loss of employment and will follow general economic trends in the economy, particularly upward movements in the unemployment rate, loss of collateral value, and demand shifts.

As of September 30, 2014, approximately 48% in principal amount of the Company's loans were secured by commercial real estate, consisting primarily of construction and land development loans and loans secured by commercial properties. Approximately 9% in principal amount of the Company's loans were residential mortgage loans. Approximately 1% in principal amount of the Company's loans were residential construction loans. Approximately 10% in principal amount of the Company's loans were for agriculture and 22% in principal amount of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 10% in principal amount of the Company's loans were consumer loans.

Once a loan becomes delinquent and repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment in full is unlikely, the Company will consider the loan to be collateral dependent and will estimate its probable loss, using a recent valuation as appropriate to the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final

collection, the Company may periodically revalue the underlying collateral and take additional charge-offs as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when collateral is liquidated and actual loss is known. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

At September 30, 2014 and December 31, 2013, all loans were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank ("FHLB") and the Federal Reserve Bank.

## Non-accrual and Past Due Loans

The Company's non-accrual loans by loan class, as of September 30, 2014 and December 31, 2013 were as follows:

| (\$ in thousands)        | September<br>30,<br>2014 | December<br>31,<br>2013 |
|--------------------------|--------------------------|-------------------------|
| Commercial               | \$2,198                  | \$2,609                 |
| Commercial Real Estate   | 1,648                    | 2,607                   |
| Agriculture              | —                        | 1,590                   |
| Residential Mortgage     | 2,039                    | 2,166                   |
| Residential Construction | 76                       | 93                      |
| Consumer                 | 675                      | 505                     |
|                          | \$6,636                  | \$9,570                 |

Non-accrual loans amounted to \$6,636,000 at September 30, 2014 and were comprised of seven residential mortgage loans totaling \$2,039,000, two residential construction loans totaling \$76,000, seven commercial real estate loans totaling \$1,648,000, seven commercial loans totaling \$2,198,000 and seven consumer loans totaling \$675,000. Non-accrual loans amounted to \$9,570,000 at December 31, 2013 and were comprised of seven residential mortgage loans totaling \$2,166,000, two residential construction loans totaling \$93,000, nine commercial real estate loans totaling \$2,607,000, three agricultural loans totaling \$1,590,000, nine commercial loans totaling \$2,609,000 and five consumer loans totaling \$505,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral.

An age analysis of past due loans, segregated by loan class, as of September 30, 2014 and December 31, 2013 is as follows:

| (\$ in thousands)         | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>more Past<br>Due | Total Past<br>Due | Current          | Total Loans      |
|---------------------------|------------------------|------------------------|--------------------------------|-------------------|------------------|------------------|
| <b>September 30, 2014</b> |                        |                        |                                |                   |                  |                  |
| Commercial                | \$—                    | \$142                  | \$192                          | \$334             | \$116,907        | \$117,241        |
| Commercial Real Estate    | 388                    | —                      | 1,156                          | 1,544             | 252,416          | 253,960          |
| Agriculture               | —                      | —                      | —                              | —                 | 55,293           | 55,293           |
| Residential Mortgage      | 1,069                  | 655                    | 119                            | 1,843             | 47,628           | 49,471           |
| Residential Construction  | 39                     | —                      | 73                             | 112               | 5,283            | 5,395            |
| Consumer                  | 76                     | —                      | 571                            | 647               | 49,851           | 50,498           |
| <b>Total</b>              | <b>\$1,572</b>         | <b>\$797</b>           | <b>\$2,111</b>                 | <b>\$4,480</b>    | <b>\$527,378</b> | <b>\$531,858</b> |
| <b>December 31, 2013</b>  |                        |                        |                                |                   |                  |                  |
| Commercial                | \$200                  | \$96                   | \$269                          | \$565             | \$110,079        | \$110,644        |
| Commercial Real Estate    | 49                     | 341                    | 531                            | 921               | 234,375          | 235,296          |
| Agriculture               | —                      | —                      | —                              | —                 | 51,730           | 51,730           |
| Residential Mortgage      | 207                    | —                      | 99                             | 306               | 52,503           | 52,809           |
| Residential Construction  | 40                     | 8                      | —                              | 48                | 10,396           | 10,444           |
| Consumer                  | 26                     | —                      | 23                             | 49                | 54,030           | 54,079           |
| <b>Total</b>              | <b>\$522</b>           | <b>\$445</b>           | <b>\$922</b>                   | <b>\$1,889</b>    | <b>\$513,113</b> | <b>\$515,002</b> |

The Company had two consumer loans totaling \$147,000 that were 90 days or more past due and still accruing at September 30, 2014. The Company had no loans 90 days or more past due and still accruing at December 31, 2013.

## Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Loans considered for impairment include non-accrual loans, troubled debt restructurings and loans with a risk rating of 6 (substandard) or worse. Once identified, impaired loans are measured individually for impairment using one of three methods: present value of expected cash flows discounted at the loan's effective interest rate; the loan's observable market price; and the fair value of collateral if the loan is collateral dependent. In general, any portion of the recorded investment in a collateral dependent loan in excess of the fair value of the collateral that can be identified as uncollectible, and is, therefore, deemed a confirmed loss, is promptly charged-off against the allowance for loan losses.

Impaired loans, segregated by loan class, as of September 30, 2014 and December 31, 2013 were as follows:

| (\$ in thousands)        | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>with no<br>Allowance | Recorded<br>Investment<br>with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--------------------------|---|--|---|---------------------------------|----------------------|
| September 30, 2014       |   |  |   |                                 |                      |
| Commercial               | \$ 2,864                                      | \$ 2,193                                       | \$ 545                                      | \$ 2,738                        | \$ 36                |
| Commercial Real Estate   | 2,758   | 1,648  | 1,092                                       | 2,740                           | 56                   |
| Agriculture              | —   | —  | —   | —                               | —                    |
| Residential Mortgage     | 6,215   | 2,039  | 3,228                                       | 5,267                           | 645                  |
| Residential Construction | 1,077   | 76   | 832   | 908                             | 111                  |
| Consumer                 | 2,088   | 804  | 882   | 1,686                           | 22                   |
| Total                    | \$ 15,002                                     | \$ 6,760                                       | \$ 6,579                                    | \$ 13,339                       | \$ 870               |
| December 31, 2013        |   |  |   |                                 |                      |
| Commercial               | \$ 5,794                                      | \$ 5,010                                       | \$ 656                                      | \$ 5,666                        | \$ 83                |
| Commercial Real Estate   | 3,746   | 2,607  | 1,122                                       | 3,729                           | 63                   |
| Agriculture              | 1,878   | 1,591  | —   | 1,591                           | —                    |
| Residential Mortgage     | 6,524   | 2,166  | 3,409                                       | 5,575                           | 701                  |
| Residential Construction | 1,115   | 94   | 849   | 943                             | 254                  |
| Consumer                 | 1,621   | 563  | 690   | 1,253                           | 24                   |
| Total                    | \$ 20,678                                     | \$ 12,031                                      | \$ 6,726                                    | \$ 18,757                       | \$ 1,125             |

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the three-month periods ended September 30, 2014 and September 30, 2013 was as follows:

| (\$ in thousands)      | Three Months Ended<br>September 30, 2014 |                                  | Three Months Ended<br>September 30, 2013 |                                  |
|------------------------|--|----------------------------------|--|----------------------------------|
|                        | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized |
| Commercial             | \$ 2,993                                 | \$ 9                             | \$ 3,335                                 | \$ 10                            |
| Commercial Real Estate | 2,930                                    | 20                               | 3,341                                    | 22                               |
| Agriculture            | —  | —                                | —  | —                                |
| Residential Mortgage   | 5,293                                    | 32                               | 5,796                                    | 42                               |

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|                          |          |      |          |      |
|--------------------------|----------|------|----------|------|
| Residential Construction | 914      | 9    | 961      | 10   |
| Consumer                 | 1,500    | 11   | 896      | 14   |
| Total                    | \$13,630 | \$81 | \$14,329 | \$98 |

15

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The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the nine-month periods ended September 30, 2014 and September 30, 2013 was as follows:

| (\$ in thousands)        | Nine Months Ended<br>September 30, 2014 |                                  | Nine Months Ended<br>September 30, 2013 |                                  |
|--------------------------|---|----------------------------------|---|----------------------------------|
|                          | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| Commercial               | \$4,039                                 | \$ 19                            | \$3,342                                 | \$ 29                            |
| Commercial Real Estate   | 3,320                                   | 58                               | 3,180                                   | 65                               |
| Agriculture              | 655                                     | —                                | —                                       | —                                |
| Residential Mortgage     | 5,389                                   | 96                               | 5,267                                   | 103                              |
| Residential Construction | 925                                     | 29                               | 1,027                                   | 33                               |
| Consumer                 | 1,482                                   | 40                               | 974                                     | 30                               |
| Total                    | \$ 15,810                               | \$ 242                           | \$ 13,790                               | \$ 260                           |

None of the interest on impaired loans was recognized using a cash basis of accounting for the three-month and nine-month periods ended September 30, 2014 and September 30, 2013.

#### Troubled Debt Restructurings

The Company's loan portfolio includes certain loans that have been modified in a Troubled Debt Restructuring ("TDR"), which are loans on which concessions in terms have been granted because of the borrowers' financial difficulties and, as a result, the Company receives less than the current market based compensation for the loan. These concessions may include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are placed on non-accrual status at the time of restructure and may only be returned to accruing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

When a loan is modified, it is measured based upon the present value of future cash flows discounted at the contractual interest rate of the original loan agreement, or the fair value of collateral less selling costs if the loan is collateral dependent. If the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through a specific allowance or a charge-off of the loan.

The Company had \$9,677,000 and \$9,929,000 in TDR loans as of September 30, 2014 and December 31, 2013, respectively. Specific reserves for TDR loans totaled \$870,000 and \$1,096,000 as of September 30, 2014 and December 31, 2013, respectively. TDR loans performing in compliance with modified terms totaled \$6,703,000 and \$6,750,000 as of September 30, 2014 and December 31, 2013, respectively. There were no commitments to advance more funds on existing TDR loans as of September 30, 2014.



There were no loans modified as troubled debt restructurings during the three-month period ended September 30, 2014. Loans modified as troubled debt restructurings during the three-month period ended September 30, 2013 were as follows:

| (\$ in thousands) | Three Months Ended September 30, 2013 |  |   |
|-------------------|---------------------------------------|--|---|
|                   | Number of Contracts                   | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial        | 1                                     | \$ 149   | \$ 149  |
| Consumer          | 3                                     | 233  | 233   |
| Total             | 4                                     | \$ 382   | \$ 382  |

Loans modified as troubled debt restructurings during the nine-month periods ended September 30, 2014 and September 30, 2013 were as follows:

| (\$ in thousands) | Nine Months Ended September 30, 2014 |  |   |
|-------------------|--------------------------------------|--|---|
|                   | Number of Contracts                  | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial        | 1                                    | \$ 49  | \$ 49   |
| Consumer          | 2                                    | 498  | 498   |
| Total             | 3                                    | \$ 547   | \$ 547  |

| (\$ in thousands)    | Nine Months Ended September 30, 2013 |  |   |
|----------------------|--------------------------------------|--|---|
|                      | Number of Contracts                  | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial           | 2                                    | \$ 393   | \$ 393  |
| Residential Mortgage | 1                                    | 568  | 377   |
| Consumer             | 3                                    | 233  | 233   |
| Total                | 6                                    | \$ 1,194   | \$ 1,003  |

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. There was one consumer loan with a recorded investment of \$49,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the three-month and nine-month periods ended September 30, 2014. There were no loans modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the three-month and nine-month periods ended September 30, 2013.

## Credit Quality Indicators

All loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and 8 equates to a Loss. For the definitions of each risk rating, see Note 4 to our condensed consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

The following table presents the risk ratings by loan class as of September 30, 2014 and December 31, 2013:

| (\$ in thousands)        | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|--------------------------|-----------|--------------------|-------------|----------|------|-----------|
| September 30, 2014       |           |                    |             |          |      |           |
| Commercial               | \$108,852 | \$2,610            | \$5,779     | \$—      | \$—  | \$117,241 |
| Commercial Real Estate   | 235,515   | 9,491              | 8,954       | —        | —    | 253,960   |
| Agriculture              | 55,293    | —                  | —           | —        | —    | 55,293    |
| Residential Mortgage     | 45,143    | 198                | 4,130       | —        | —    | 49,471    |
| Residential Construction | 4,809     | 470                | 116         | —        | —    | 5,395     |
| Consumer                 | 46,394    | 944                | 3,160       | —        | —    | 50,498    |
| Total                    | \$496,006 | \$13,713           | \$22,139    | \$—      | \$—  | \$531,858 |
| December 31, 2013        |           |                    |             |          |      |           |
| Commercial               | \$98,755  | \$2,762            | \$9,127     | \$—      | \$—  | \$110,644 |
| Commercial Real Estate   | 218,884   | 5,978              | 10,434      | —        | —    | 235,296   |
| Agriculture              | 50,139    | —                  | 1,591       | —        | —    | 51,730    |
| Residential Mortgage     | 48,519    | 539                | 3,751       | —        | —    | 52,809    |
| Residential Construction | 7,823     | 1,167              | 1,454       | —        | —    | 10,444    |
| Consumer                 | 48,903    | 2,585              | 2,591       | —        | —    | 54,079    |
| Total                    | \$473,023 | \$13,031           | \$28,948    | \$—      | \$—  | \$515,002 |

## Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2014:

## Three-month period ended September 30, 2014

| (\$ in thousands)                | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total   |
|----------------------------------|------------|-------------|-------------|-------------|--------------------------|----------|-------------|---------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |         |
| Balance as of June 30, 2014      | \$ 3,471   | \$ 1,691    | \$ 439      | \$ 1,126    | \$ 196                   | \$ 1,013 | \$ 238      | \$8,174 |
| Provision for loan losses        | 314        | (66 )       | 108         | 53          | (77 )                    | (58 )    | 126         | 400     |
| Charge-offs                      | (203 )     | —           | —           | —           | —                        | (50 )    | —           | (253 )  |
| Recoveries                       | 12         | —           | —           | —           | 42                       | 27       | —           | 81      |
| Net charge-offs                  | (191 )     | —           | —           | —           | 42                       | (23 )    | —           | (172 )  |
| Balance as of September 30, 2014 | \$ 3,594   | \$ 1,625    | \$ 547      | \$ 1,179    | \$ 161                   | \$ 932   | \$ 364      | \$8,402 |

## Nine-month period ended September 30, 2014

| (\$ in thousands)                | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total    |
|----------------------------------|------------|-------------|-------------|-------------|--------------------------|----------|-------------|----------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |          |
| Balance as of December 31, 2013  | \$ 3,199   | \$ 2,290    | \$ 557      | \$ 1,216    | \$ 441                   | \$ 1,023 | \$ 627      | \$9,353  |
| Provision for loan losses        | 2,637      | (596 )      | (10 )       | (37 )       | (325 )                   | 194      | (263 )      | 1,600    |
| Charge-offs                      | (2,288 )   | (69 )       | —           | —           | —                        | (378 )   | —           | (2,735 ) |
| Recoveries                       | 46         | —           | —           | —           | 45                       | 93       | —           | 184      |
| Net charge-offs                  | (2,242 )   | (69 )       | —           | —           | 45                       | (285 )   | —           | (2,551 ) |
| Balance as of September 30, 2014 | \$ 3,594   | \$ 1,625    | \$ 547      | \$ 1,179    | \$ 161                   | \$ 932   | \$ 364      | \$8,402  |

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2014:

| (\$ in thousands)                           | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total |
|---|------------|-------------|-------------|-------------|--------------------------|----------|-------------|-------|
|   | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |       |
| Period-end amount allocated to:             |            |             |             |             |                          |          |             |       |
| Loans individually evaluated for impairment | \$ 36      | \$ 56       | \$ —        | \$ 645      | \$ 111                   | \$ 22    | \$ —        | \$870 |

|   |          |          |        |          |        |        |        |         |
|---|----------|----------|--------|----------|--------|--------|--------|---------|
| Loans collectively<br>evaluated for<br>impairment | 3,558    | 1,569    | 547    | 534      | 50     | 910    | 364    | 7,532   |
| Ending Balance                                    | \$ 3,594 | \$ 1,625 | \$ 547 | \$ 1,179 | \$ 161 | \$ 932 | \$ 364 | \$8,402 |

The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2013:

Three-month period ended September 30, 2013

| (\$ in thousands)                | Commercial |             |             |                      |                          |          |        | Unallocated | Total |
|----------------------------------|------------|-------------|-------------|----------------------|--------------------------|----------|--------|-------------|-------|
|                                  | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |        |             |       |
| Balance as of June, 30, 2013     | \$ 2,869   | \$ 2,037    | \$ 748      | \$ 1,054             | \$ 503                   | \$ 1,041 | \$ 474 | \$8,726     |       |
| Provision for loan losses        | 191        | 309         | (137 )      | (127 )               | (70 )                    | 126      | (292 ) | —           |       |
| Charge-offs                      | (1 )       | —           | —           | —                    | —                        | (115 )   | —      | (116 )      |       |
| Recoveries                       | 25         | —           | —           | 145                  | 1                        | 11       | —      | 182         |       |
| Net charge-offs                  | 24         | —           | —           | 145                  | 1                        | (104 )   | —      | 66          |       |
| Balance as of September 30, 2013 | \$ 3,084   | \$ 2,346    | \$ 611      | \$ 1,072             | \$ 434                   | \$ 1,063 | \$ 182 | \$8,792     |       |

Nine-month period ended September 30, 2013

| (\$ in thousands)                | Commercial |             |             |                      |                          |          |        | Unallocated | Total |
|----------------------------------|------------|-------------|-------------|----------------------|--------------------------|----------|--------|-------------|-------|
|                                  | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |        |             |       |
| Balance as of December 31, 2012  | \$ 2,899   | \$ 1,723    | \$ 915      | \$ 1,148             | \$ 724                   | \$ 1,110 | \$ 35  | \$8,554     |       |
| Provision for loan losses        | 149        | 575         | (306 )      | 100                  | (207 )                   | 342      | 147    | 800         |       |
| Charge-offs                      | (113 )     | (3 )        | (1 )        | (333 )               | (127 )                   | (491 )   | —      | (1,068 )    |       |
| Recoveries                       | 149        | 51          | 3           | 157                  | 44                       | 102      | —      | 506         |       |
| Net charge-offs                  | 36         | 48          | 2           | (176 )               | (83 )                    | (389 )   | —      | (562 )      |       |
| Balance as of September 30, 2013 | \$ 3,084   | \$ 2,346    | \$ 611      | \$ 1,072             | \$ 434                   | \$ 1,063 | \$ 182 | \$8,792     |       |

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2013:

| (\$ in thousands)                           | Commercial |             |             |                      |                          |          |      | Unallocated | Total |
|---|------------|-------------|-------------|----------------------|--------------------------|----------|------|-------------|-------|
|   | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |      |             |       |
| Period-end amount allocated to:             |            |             |             |                      |                          |          |      |             |       |
| Loans individually evaluated for impairment | \$ 107     | \$ 20       | \$ —        | \$ 622               | \$ 252                   | \$ 74    | \$ — | \$1,075     |       |

|   |          |          |        |          |        |          |        |         |
|---|----------|----------|--------|----------|--------|----------|--------|---------|
| Loans collectively<br>evaluated for<br>impairment | 2,977    | 2,326    | 611    | 450      | 182    | 989      | 182    | 7,717   |
| Ending Balance                                    | \$ 3,084 | \$ 2,346 | \$ 611 | \$ 1,072 | \$ 434 | \$ 1,063 | \$ 182 | \$8,792 |

20

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The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the period ended December 31, 2013:

Year ended December 31, 2013

| (\$ in thousands)                           | Commercial |             | Agriculture | Residential |                          | Consumer | Unallocated | Total    |
|---|------------|-------------|-------------|-------------|--------------------------|----------|-------------|----------|
|   | Commercial | Real Estate |             | Mortgage    | Residential Construction |          |             |          |
| Balance as of December 31, 2012             | \$ 2,899   | \$ 1,723    | \$ 915      | \$ 1,148    | \$ 724                   | \$ 1,110 | \$ 35       | \$ 8,554 |
| Provision for (reversal of) loan losses     | 91         | 533         | (360 )      | 244         | (201 )                   | 301      | 592         | 1,200    |
| Charge-offs                                 | (168 )     | (17 )       | (1 )        | (333 )      | (127 )                   | (572 )   | —           | (1,218 ) |
| Recoveries                                  | 377        | 51          | 3           | 157         | 45                       | 184      | —           | 817      |
| Net charge-offs                             | 209        | 34          | 2           | (176 )      | (82 )                    | (388 )   | —           | (401 )   |
| Ending Balance                              | 3,199      | 2,290       | 557         | 1,216       | 441                      | 1,023    | 627         | 9,353    |
| Period-end amount allocated to:             |            |             |             |             |                          |          |             |          |
| Loans individually evaluated for impairment | 83         | 63          | —           | 701         | 254                      | 24       | —           | 1,125    |
| Loans collectively evaluated for impairment | 3,116      | 2,227       | 557         | 515         | 187                      | 999      | 627         | 8,228    |
| Balance as of December 31, 2013             | \$ 3,199   | \$ 2,290    | \$ 557      | \$ 1,216    | \$ 441                   | \$ 1,023 | \$ 627      | \$ 9,353 |

The Company's investment in loans as of September 30, 2014, September 30, 2013, and December 31, 2013 related to each balance in the allowance for loan losses by loan class and disaggregated on the basis of the Company's impairment methodology was as follows:

| (\$ in thousands)                           | Commercial |             | Agriculture | Residential |                          | Consumer  | Total      |
|---|------------|-------------|-------------|-------------|--------------------------|-----------|------------|
|   | Commercial | Real Estate |             | Mortgage    | Residential Construction |           |            |
| September 30, 2014                          |            |             |             |             |                          |           |            |
| Loans individually evaluated for impairment | \$ 2,738   | \$ 2,740    | \$—         | \$ 5,267    | \$ 908                   | \$ 1,686  | \$ 13,339  |
| Loans collectively evaluated for impairment | 114,503    | 251,220     | 55,293      | 44,204      | 4,487                    | 48,812    | 518,519    |
| Ending Balance                              | \$ 117,241 | \$ 253,960  | \$ 55,293   | \$ 49,471   | \$ 5,395                 | \$ 50,498 | \$ 531,858 |
| September 30, 2013                          |            |             |             |             |                          |           |            |
| Loans individually evaluated for            | \$ 3,410   | \$ 3,078    | \$—         | \$ 5,647    | \$ 955                   | \$ 903    | \$ 13,993  |

impairment

Loans

collectively  
evaluated for

|                |            |            |           |           |          |           |            |
|----------------|------------|------------|-----------|-----------|----------|-----------|------------|
| impairment     | 103,341    | 227,206    | 49,657    | 47,197    | 8,599    | 54,967    | 490,967    |
| Ending Balance | \$ 106,751 | \$ 230,284 | \$ 49,657 | \$ 52,844 | \$ 9,554 | \$ 55,870 | \$ 504,960 |

December 31, 2013

Loans

individually  
evaluated for  
impairment

|  |          |          |          |          |        |          |           |
|--|----------|----------|----------|----------|--------|----------|-----------|
|  | \$ 5,666 | \$ 3,729 | \$ 1,591 | \$ 5,575 | \$ 943 | \$ 1,253 | \$ 18,757 |
|--|----------|----------|----------|----------|--------|----------|-----------|

Loans

collectively  
evaluated for

|                |            |            |           |           |           |           |            |
|----------------|------------|------------|-----------|-----------|-----------|-----------|------------|
| impairment     | 104,978    | 231,567    | 50,139    | 47,234    | 9,501     | 52,826    | 496,245    |
| Ending Balance | \$ 110,644 | \$ 235,296 | \$ 51,730 | \$ 52,809 | \$ 10,444 | \$ 54,079 | \$ 515,002 |



### 3. MORTGAGE OPERATIONS

Transfers and servicing of financial assets and extinguishments of liabilities are accounted for and reported based on consistent application of a financial-components approach that focuses on control. Transfers of financial assets that are sales are distinguished from transfers that are secured borrowings. Retained interests (mortgage servicing rights) in loans sold are measured by allocating the previous carrying amount of the transferred assets between the loans sold and retained interests, if any, based on their relative fair value at the date of transfer. Fair values are estimated using discounted cash flows based on a current market interest rate.

The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold. The Company sold substantially its entire portfolio of conforming long-term residential mortgage loans originated during the nine months ended September 30, 2014 for cash proceeds equal to the fair value of the loans.

The recorded value of mortgage servicing rights is included in other assets on the condensed consolidated balance sheets, and is amortized in proportion to, and over the period of, estimated net servicing revenues. The Company assesses capitalized mortgage servicing rights for impairment based upon the fair value of those rights at each reporting date. For purposes of measuring impairment, the rights are stratified based upon the product type, term and interest rates. Fair value is determined by discounting estimated net future cash flows from mortgage servicing activities using discount rates that approximate current market rates and estimated prepayment rates, among other assumptions. The amount of impairment recognized, if any, is the amount by which the capitalized mortgage servicing rights for a stratum exceeds their fair value. Impairment, if any, is recognized through a valuation allowance for each individual stratum. Changes in the carrying amount of mortgage servicing rights are reported in earnings under other operating income on the condensed consolidated statements of income.

Key assumptions used in measuring the fair value of mortgage servicing rights as of September 30, 2014 and December 31, 2013 were as follows:

|                               | September<br>30, 2014 |   | December<br>31, 2013 |   |
|-------------------------------|-----------------------|---|----------------------|---|
| Constant prepayment rate      | 11.36                 | % | 9.09                 | % |
| Discount rate                 | 10.05                 | % | 10.05                | % |
| Weighted average life (years) | 6.49                  |   | 7.05                 |   |

At September 30, 2014 and December 31, 2013, the Company's mortgage loans held-for-sale was \$1,258,000 and \$1,263,000, respectively. At September 30, 2014, and December 31, 2013, the Company serviced real estate mortgage loans for others totaling \$239,351,000 and \$243,299,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2014 and December 31, 2013. Mortgage servicing rights are included in Interest Receivable and Other Assets on the condensed consolidated balance sheets:

|                           | (in thousands)       |           |            |                       |
|---------------------------|----------------------|-----------|------------|-----------------------|
|                           | December<br>31, 2013 | Additions | Reductions | September<br>30, 2014 |
| Mortgage servicing rights | \$1,968              | \$170     | \$(260)    | \$1,878               |
| Valuation allowance       | —                    | —         | —          | —                     |

|   |         |       |        |   |         |
|---|---------|-------|--------|---|---------|
| Mortgage servicing rights, net of valuation allowance | \$1,968 | \$170 | \$(260 | ) | \$1,878 |
|---|---------|-------|--------|---|---------|

At September 30, 2014 and December 31, 2013, the estimated fair market value of the Company's mortgage servicing rights asset was \$2,126,000 and \$2,326,000, respectively.

The Company received contractually specified servicing fees of \$152,000 and \$155,000 for the three month periods ended September 30, 2014 and September 30, 2013, respectively. The Company received contractually specified servicing fees of \$456,000 and \$462,000 for the nine month periods ended September 30, 2014 and September 30, 2013, respectively. Contractually specified servicing fees are included in other operating Income on the condensed consolidated statements of income.

## 4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 23, 2014, the Board of Directors of the Company declared a 3% stock dividend payable as of March 31, 2014. All income per share amounts have been adjusted to give retroactive effect to stock dividends.

## Earnings Per Share (EPS)

Basic EPS includes no dilution and is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the respective period. Quarter-to-date diluted EPS is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding plus dilutive shares for the quarter. Year-to-date diluted EPS is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding plus average dilutive shares year-to-date. Diluted shares include all common stock equivalents ("in-the-money" stock options, unvested restricted stock, stock units, warrants and rights, convertible bonds and preferred stock), which reflects the potential dilution of securities that could share in the earnings of the Company.

The following table presents a reconciliation of basic and diluted EPS for the three-month and nine-month period ended September 30, 2014 and 2013.

|   | Three months ended<br>September 30, |           | Nine Months ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2014                                | 2013      | 2014                               | 2013      |
| Basic earnings per share:                           |                                     |           |                                    |           |
| Net income  | \$1,570                             | \$1,373   | \$4,273                            | \$4,178   |
| Preferred stock dividend                            | \$(33 )                             | \$(162 )  | \$(97 )                            | \$(534 )  |
| Net income available to common stockholders         | \$1,537                             | \$1,211   | \$4,176                            | \$3,644   |
| Weighted average common shares outstanding          | 9,729,443                           | 9,701,098 | 9,724,986                          | 9,696,042 |
| Basic EPS   | \$0.16                              | \$0.12    | \$0.43                             | \$0.38    |
| Diluted earnings per share:                         |                                     |           |                                    |           |
| Net income  | \$1,570                             | \$1,373   | \$4,273                            | \$4,178   |
| Preferred stock dividend                            | \$(33 )                             | \$(162 )  | \$(97 )                            | \$(534 )  |
| Net income available to common stockholders         | \$1,537                             | \$1,211   | \$4,176                            | \$3,644   |
| Weighted average common shares outstanding          | 9,729,443                           | 9,701,098 | 9,724,986                          | 9,696,042 |
| Effect of dilutive shares                           | 52,440                              | 38,862    | 49,534                             | 34,897    |
| Adjusted weighted average common shares outstanding | 9,781,883                           | 9,739,960 | 9,774,520                          | 9,730,939 |
| Diluted EPS   | \$0.16                              | \$0.12    | \$0.43                             | \$0.37    |

Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 220,467 shares and 310,847 shares for the three-month periods ended September 30, 2014 and 2013, respectively. Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 236,137 shares and 322,949 shares for the nine-month periods ended September 30, 2014 and 2013, respectively. There were no non-vested shares of restricted stock not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect for the three-month periods ended September 30, 2014 and 2013. Non-vested shares of restricted stock that were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 8,205 shares and 2,852 shares for the nine-month periods ended September 30, 2014 and 2013, respectively.

## 5. STOCK PLANS

On January 23, 2014, the Board of Directors of the Company declared a 3% stock dividend payable as of March 31, 2014. All stock options and restricted stock outstanding have been adjusted to give retroactive effect to stock dividends.

The following table presents the activity related to stock options for the three months ended September 30, 2014:

|  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|--|---------------------|--|---------------------------------|---|
| Options outstanding at Beginning of Period | 301,457             | \$ 12.01                                 |                                 |   |
| Granted                                    | —                   | —  |                                 |   |
| Expired                                    | —                   | —  |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  |                                 |   |
| Options outstanding at End of Period       | 301,457             | \$ 12.01                                 | \$ 231,049                      | 3.21  |
| Exercisable (vested) at End of Period      | 253,265             | \$ 13.13                                 | \$ 160,204                      | 2.20  |

The following table presents the activity related to stock options for the nine months ended September 30, 2014:

|  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|--|---------------------|--|---------------------------------|---|
| Options outstanding at Beginning of Period | 368,177             | \$ 11.52                                 |                                 |   |
| Granted                                    | 18,967              | \$ 7.28                                  |                                 |   |
| Expired                                    | (85,687 )           | \$ 8.89                                  |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  |                                 |   |
| Options outstanding at End of Period       | 301,457             | \$ 12.01                                 | \$ 231,049                      | 3.21  |
| Exercisable (vested) at End of Period      | 253,265             | \$ 13.13                                 | \$ 160,204                      | 2.20  |

The weighted average grant date fair value per share of options granted during the nine-month period ended September 30, 2014 was \$3.03 per share.

As of September 30, 2014, there was \$103,000 of total unrecognized compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted average period of approximately 2.68 years.

There was \$35,000 of recognized compensation cost related to stock options granted for the nine months ended September 30, 2014.

A summary of the weighted average assumptions used in valuing stock options during the three months and nine months ended September 30, 2014 is presented below:

|                           | Three<br>Months<br>Ended<br>September<br>30, 2014* | Nine<br>Months Ended<br>September 30,<br>2014 |   |
|---------------------------|--|---|---|
| Risk Free Interest Rate   | —  | 1.53  | % |
| Expected Dividend Yield   | —  | 0.00  | % |
| Expected Life in Years    | —  | 5   |   |
| Expected Price Volatility | —  | 45.93   | % |

\* There were no stock options granted during the three-month period ended September 30, 2014.

The following table presents the activity related to non-vested restricted stock for the three months ended September 30, 2014:

|   | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual Term (in<br>years) |
|---|---------------------|---|------------------------------|---|
| Non-vested Restricted stock outstanding at<br>Beginning of Period | 71,013              | \$5.87  |                              |   |
| Granted   | —                   | —   |                              |   |
| Cancelled / Forfeited   | —                   | —   |                              |   |
| Exercised/Released/Vested   | —                   | —   |                              |   |
| Non-vested restricted stock outstanding at End<br>of Period       | 71,013              | \$5.87  | \$536,148                    | 8.22  |

The following table presents the activity related to non-vested restricted stock for the nine months ended September 30, 2014:

|   | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual Term (in<br>years) |
|---|---------------------|---|------------------------------|---|
| Non-vested Restricted stock outstanding at<br>Beginning of Period | 61,541              | \$4.88  |                              |   |
| Granted   | 24,890              | \$7.28  |                              |   |

|  |           |        |           |      |
|--|-----------|--------|-----------|------|
| Cancelled / Forfeited                                    | (4,230 )  | \$4.74 |           |      |
| Exercised/Released/Vested                                | (11,188 ) | \$4.01 |           |      |
| Non-vested restricted stock outstanding at End of Period | 71,013    | \$5.87 | \$536,148 | 8.22 |

The weighted average fair value of restricted stock granted during the nine month period ended September 30, 2014 was \$7.28 per share.

As of September 30, 2014, there was \$244,000 of total unrecognized compensation cost related to non-vested restricted stock. This cost is expected to be recognized over a weighted average period of approximately 2.75 years.

There was \$81,000 of recognized compensation cost related to restricted stock awards for the nine month ended September 30, 2014.



The Company has an Employee Stock Purchase Plan (“ESPP”). Under the ESPP, the Company is authorized to issue to eligible employees shares of common stock. There are 309,986 (adjusted for the 2014 stock dividend) shares authorized under the ESPP. The ESPP will terminate March 15, 2016. The ESPP is implemented by participation periods of not more than twenty-seven months each. The Board of Directors determines the commencement date and duration of each participation period. The Board of Directors approved the current participation period of November 24, 2013 to November 23, 2014. An eligible employee is one who has been continually employed for at least 90 days prior to commencement of a participation period. Under the terms of the ESPP, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company’s common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair value on the last trading day before the date of participation or the fair value on the last trading day during the participation period.

As of September 30, 2014, there was \$4,000 of unrecognized compensation cost related to ESPP issuances. This cost is expected to be recognized over a weighted average period of approximately 0.25 years.

There was \$23,000 of recognized compensation cost related to ESPP issuances for the nine-month period ended September 30, 2014.

The weighted average fair value at issuance date during the nine-month period ended September 30, 2014 was \$1.56.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three months and nine month ended September 30, 2014 is presented below:

|                           | Three<br>Months<br>Ended<br>September<br>30, 2014 |   | Nine<br>Months Ended<br>September 30,<br>2014 |   |
|---------------------------|---|---|---|---|
| Risk Free Interest Rate   | 0.12  | % | 0.12  | % |
| Expected Dividend Yield   | 0.00  | % | 0.00  | % |
| Expected Life in Years    | 1.00  |   | 1.00  |   |
| Expected Price Volatility | 20.00   | % | 20.00   | % |

## 6. FAIR VALUE MEASUREMENT

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale and trading securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a non-recurring basis, such as loans held-for-sale, loans held-for-investment and certain other assets. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally corresponds with the Company's quarterly valuation process.

### Fair Value Hierarchy

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.
- Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models, and similar techniques and include management judgment and estimation which may be significant.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

### Investment Securities Available-for-Sale

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets where valuations include significant unobservable assumptions.

### Loans Held-for-Sale

Loans held-for-sale are carried at the lower of cost or fair value. The fair value of loans held-for-sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies

loans subjected to non-recurring fair value adjustments as Level 2. At September 30, 2014 there were no loans held-for-sale that required a write-down.

#### Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, the Company measures impairment. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Inputs include external appraised values, management assumptions regarding market trends or other relevant factors, selling and commission costs ranging from 6% to 7%, and amount and timing of cash flows based upon current discount rates. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

At September 30, 2014, certain impaired loans were considered collateral dependent and were evaluated based on the fair value of the underlying collateral securing the loan. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When a loan is evaluated based on the fair value of the underlying collateral securing the loan, the Company records the impaired loan as non-recurring Level 3.

#### Other Real Estate Owned

Other real estate assets (“OREO”) acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy.

#### Loan Servicing Rights

Loan servicing rights are subject to impairment testing. The Company utilizes a third party service provider to calculate the fair value of the Company’s loan servicing rights. Loan servicing rights are measured at fair value as of the date of sale. The Company uses quoted market prices when available. Subsequent fair value measurements are determined using a discounted cash flow model. In order to determine the fair value of the loan servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income.

The model used to calculate the fair value of the Company’s loan servicing rights is periodically validated by an independent external model validation group. The model assumptions and the loan servicing rights fair value estimates are also compared to observable trades of similar portfolios as well as to loan servicing rights broker valuations and industry surveys, as available. If the valuation model reflects a value less than the carrying value, loan servicing rights are adjusted to fair value through a valuation allowance as determined by the model. As such, the Company classifies loan servicing rights subjected to non-recurring fair value adjustments as Level 3.

#### Assets Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of September 30, 2014:

| September 30, 2014                                      | (in thousands) |         |           |         |
|---|----------------|---------|-----------|---------|
|   | Total          | Level 1 | Level 2   | Level 3 |
| Securities of U.S. government agencies and corporations | \$34,776       | \$—     | \$34,776  | \$—     |
| Obligations of states and political subdivisions        | 21,435         | —       | 21,435    | —       |
| Collateralized mortgage obligations                     | 10,115         | —       | 10,115    | —       |
| Mortgage-backed securities                              | 77,463         | —       | 77,463    | —       |
| Total investments at fair value                         | \$143,789      | \$—     | \$143,789 | \$—     |



The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2013:

| December 31, 2013                                       | Total     | (in thousands) |           |         |
|---|-----------|----------------|-----------|---------|
|   |           | Level 1        | Level 2   | Level 3 |
| Securities of U.S. government agencies and corporations | \$52,685  | \$—            | \$52,685  | \$—     |
| Obligations of states and political subdivisions        | 27,387    | —              | 27,387    | —       |
| Collateralized mortgage obligations                     | 5,405     | —              | 5,405     | —       |
| Mortgage-backed securities                              | 87,792    | —              | 87,792    | —       |
| Total investments at fair value                         | \$173,269 | \$—            | \$173,269 | \$—     |

#### Assets Recorded at Fair Value on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of September 30, 2014:

| September 30, 2014         | Total | (in thousands) |         |         |
|----------------------------|-------|----------------|---------|---------|
|                            |       | Level 1        | Level 2 | Level 3 |
| Impaired loans             | \$150 | \$—            | \$—     | \$150   |
| Total assets at fair value | \$150 | \$—            | \$—     | \$150   |

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of December 31, 2013:

| December 31, 2013          | Total   | (in thousands) |         |         |
|----------------------------|---------|----------------|---------|---------|
|                            |         | Level 1        | Level 2 | Level 3 |
| Impaired loans             | \$1,095 | \$—            | \$—     | \$1,095 |
| Loan servicing rights      | 1,968   | —              | —       | 1,968   |
| Total assets at fair value | \$3,063 | \$—            | \$—     | \$3,063 |

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2014 and December 31, 2013.

Key methods and assumptions used in measuring the fair value of impaired loans and loan servicing rights as of September 30, 2014 and December 31, 2013 were as follows:

| Method | Assumption Inputs |
|--------|-------------------|
|--------|-------------------|

|                       |   |  |
|-----------------------|---|--|
| Impaired loans        | Collateral, market, income, enterprise, liquidation and discounted Cash Flows | External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 7%.   |
| Loan servicing rights | Discounted cash flows   | Present value of expected future cash flows is estimated using a discount rate factor of 10.05% as of September 30, 2014 and December 31, 2013. A constant prepayment rate of 11.36% and 9.09% as of September 30, 2014 and December 31, 2013, respectively, was utilized. |

## 7. PREFERRED STOCK

On September 15, 2011, the Company issued to the U.S. Treasury under the United States Department of Treasury Small Business Lending Fund (SBLF) 22,847 shares of the Company's Non-Cumulative Perpetual Preferred Stock, Series A (SBLF Shares), having a liquidation preference per share equal to \$1,000, for an aggregate purchase price of \$22,847,000.

On September 15, 2011, the Company redeemed from the U.S. Treasury, using the partial proceeds from the issuance of the SBLF Shares, all 17,390 outstanding shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, liquidation amount \$1,000 per share, for a redemption price of \$17,390,000, plus accrued but unpaid dividends at the date of redemption.

On February 8, 2013, the Company redeemed \$10,000,000 of the \$22,847,000 in preferred stock it issued to the U.S. Treasury under the SBLF program.

## 8. FAIR VALUES OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

### Cash and Cash Equivalents

The carrying amounts reported in the condensed consolidated balance sheets for cash and short-term instruments are a reasonable estimate of fair value. The carrying amount is a reasonable estimate of fair value because of the relatively short term between the origination of the instrument and its expected realization. Therefore, the Company believes the measurement of fair value of cash and cash equivalents is derived from Level 1 inputs.

### Other Equity Securities

The carrying amounts reported in the condensed consolidated balance sheets approximate fair value as the shares can only be redeemed by the issuing institution. The Company believes the measurement of the fair value of other equity securities is derived from Level 2 inputs.

### Loans Receivable

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., commercial real estate and rental property mortgage loans, commercial and industrial loans, and agricultural loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. Given that there are loans with specific terms that are not readily available, the Company believes the fair value of loans receivable is derived from Level 3 inputs.

### Loans Held-for-Sale

For loans held for sale, the fair value is based on what secondary markets are currently offering for portfolios with similar characteristics. See FN(6), Fair Value Measurement.



Interest Receivable and Payable

The carrying amount of interest receivable and payable approximates its fair value. The Company believes the measurement of the fair value of interest receivable and payable is derived from Level 2 inputs.

### Mortgage Servicing Rights

The Company uses quoted market prices when available. Subsequent fair value measurements are determined using a discounted cash flow model. In order to determine the fair value of the MSR, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. This model is periodically validated by an independent external model validation group. The model assumptions and the MSR fair value estimates are also compared to observable trades of similar portfolios as well as to MSR broker valuations and industry surveys, as available.

### Deposit Liabilities

The Company measures fair value of deposits using Level 2 and Level 3 inputs. The fair value of deposits were derived by discounting their expected future cash flows back to their present values based on the FHLB yield curve, and their expected decay rates for non maturing deposits. The Company is able to obtain FHLB yield curve rates as of the measurement date, and believes these inputs fall under Level 2 of the fair value hierarchy. Decay rates were developed through internal analysis, and are supported by recent years of the Bank's transaction history. The inputs used by the Company to derive the decay rate assumptions are unobservable inputs, and therefore fall under Level 3 of the fair value hierarchy.

### Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on-and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial assets or liabilities include deferred tax liabilities and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in many of the estimates.

The estimated fair values of the Company's financial instruments for the periods ended September 30, 2014 and December 31, 2013 are approximately as follows:

|                           |       | September 30, 2014 |            | December 31, 2013 |            |
|---------------------------|-------|--------------------|------------|-------------------|------------|
|                           | Level | Carrying amount    | Fair value | Carrying amount   | Fair value |
| Financial assets:         |       |                    |            |                   |            |
| Cash and cash equivalents | 1     | \$246,628          | \$246,628  | \$177,254         | \$177,254  |
| Other equity securities   | 2     | 3,934              | 3,934      | 3,717             | 3,717      |
| Loans receivable:         |       |                    |            |                   |            |
| Net loans                 | 3     | 524,796            | 523,975    | 506,850           | 503,605    |
| Loans held-for-sale       | 2     | 1,258              | 1,287      | 1,263             | 1,290      |

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|                           |   |         |         |         |         |
|---------------------------|---|---------|---------|---------|---------|
| Interest receivable       | 2 | 2,701   | 2,701   | 2,636   | 2,636   |
| Mortgage servicing rights | 3 | 1,878   | 2,126   | 1,968   | 2,326   |
| Financial liabilities:    |   |         |         |         |         |
| Deposits                  | 3 | 855,778 | 841,530 | 803,787 | 789,841 |
| Interest payable          | 2 | 86      | 86      | 71      | 71      |

## 9. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2014 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|---------------------|----------------------|-------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                         |
| Securities of U.S. government agencies and corporations | \$35,299          | \$7                 | \$(530 )             | \$34,776                |
| Obligations of states and political subdivisions        | 20,993            | 520                 | (78 )                | 21,435                  |
| Collateralized mortgage obligations                     | 10,096            | 42                  | (23 )                | 10,115                  |
| Mortgage-backed securities                              | 76,716            | 944                 | (197 )               | 77,463                  |
| Total debt securities                                   | \$143,104         | \$1,513             | \$(828 )             | \$143,789               |

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2013 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|---------------------|----------------------|-------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                         |
| Securities of U.S. government agencies and corporations | \$53,960          | \$8                 | \$ (1,283— )         | \$52,685                |
| Obligations of states and political subdivisions        | 27,528            | 409                 | (550 )               | 27,387                  |
| Collateralized mortgage obligations                     | 5,359             | 46                  | —                    | 5,405                   |
| Mortgage-backed securities                              | 87,486            | 718                 | (412 )               | 87,792                  |
| Total debt securities                                   | \$174,333         | \$1,181             | \$(2,245 )           | \$173,269               |

The Company had \$12,140,000 in proceeds from sales of available-for-sale securities for the nine-month and three-month periods September 30, 2014. The Company had no proceeds from sales of available-for-sale securities for the nine-month and three-month periods September 30, 2013. Gross realized gains from sales or a calls of available-for-sale securities were \$292,000 for the nine-month and three-month periods ended September 30, 2014. Gross realized gains from sales or a calls of available-for-sale securities were \$4,000 and \$0 for the nine-month and three-month periods ended September 30, 2013. Gross realized losses from sales or a calls of available-for-sale securities were \$239,000 for the nine-month and three-month periods ended September 30, 2014. There were no gross realized losses from sales or calls of available-for-sale securities for the nine-month and three-month periods ended September 30, 2013. For the nine-month and three-month periods ended September 30, 2014, there was \$50,000 and \$0, respectively, gross realized loss from other equity securities.

The amortized cost and estimated market value of debt and other securities at September 30, 2014, by contractual and expected maturity, are shown in the following table:

| (in thousands)                         | Amortized<br>cost | Estimated<br>fair value |
|--|-------------------|-------------------------|
| Due in one year or less                | \$7,688           | \$7,695                 |
| Due after one year through five years  | 109,683           | 110,167                 |
| Due after five years through ten years | 23,796            | 23,893                  |
| Due after ten years                    | 1,937             | 2,034                   |
|  | \$143,104         | \$143,789               |

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities due after one year through five years included mortgage-backed securities and collateralized mortgage obligations with expected maturities totaling \$82,300,000. The maturities on these securities were based on the average lives of the securities.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of September 30, 2014, follows:

| (in thousands)  | Less than 12 months<br>Fair Value | Unrealized<br>losses | 12 months or more<br>Fair Value | Unrealized<br>losses | Total<br>Fair Value | Unrealized<br>losses |
|---|-----------------------------------|----------------------|---------------------------------|----------------------|---------------------|----------------------|
| Securities of U.S. government agencies and corporations | \$4,629                           | \$(6 )               | \$21,574                        | \$(524 )             | \$26,203            | \$(530 )             |
| Obligations of states and political subdivisions        | 1,588                             | (27 )                | 4,790                           | (51 )                | 6,378               | (78 )                |
| Collateralized Mortgage obligations                     | 4,048                             | (23 )                | —                               | —                    | 4,048               | (23 )                |
| Mortgaged-backed securities                             | 3,703                             | (12 )                | 11,130                          | (185 )               | 14,833              | (197 )               |
| Total   | \$13,968                          | \$(68 )              | \$37,494                        | \$(760 )             | \$51,462            | \$(828 )             |

No decline in value was considered “other-than-temporary” during 2014. Twelve securities, all considered investment grade, which had a fair value of \$13,968,000 and a total unrealized loss of \$68,000 have been in an unrealized loss position for less than twelve months as of September 30, 2014. Thirty two securities, all considered investment grade, which had a fair value of \$37,494,000 and a total unrealized loss of \$760,000 had been in an unrealized loss position for more than twelve months as of September 30, 2014. The declines in fair value were attributable to changes in interest rates. We have evaluated the credit ratings of our investment securities and their issuer and/or insurers, and based on this evaluation have determined that no investment security in our investment portfolio is other-than-temporarily impaired. As the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities prior to their anticipated recovery, these investments are not considered other-than-temporarily impaired.



An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2013, follows:

|   | Less than 12 months<br>Fair Value | Unrealized<br>losses | 12 months or more<br>Fair Value | Unrealized<br>losses | Total<br>Fair Value | Unrealized<br>losses |
|---|-----------------------------------|----------------------|---------------------------------|----------------------|---------------------|----------------------|
| Securities of U.S. government agencies and corporations | \$46,654                          | \$(1,283 )           | \$—                             | \$—                  | \$46,654            | (1,283 )             |
| Obligations of states and political subdivisions        | 11,871                            | (550 )               | —                               | —                    | 11,871              | (550 )               |
| Mortgage-backed securities                              | 19,155                            | (243 )               | 6,932                           | (169 )               | 26,087              | (412 )               |
| <b>Total</b>  | <b>\$77,680</b>                   | <b>\$(2,076 )</b>    | <b>\$6,932</b>                  | <b>\$(169 )</b>      | <b>\$84,612</b>     | <b>\$(2,245 )</b>    |

Investment securities carried at \$28,989,000 and \$28,773,000 at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

## 10. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table details activity in accumulated other comprehensive income (loss) for the three-month period ended September 30, 2014:

| (\$ in thousands)                       | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|---|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of June 30, 2014             | \$638                                | \$(480)                         | \$46                             | \$ 204   |
| Current period other comprehensive loss | (228)                                | —                               | —                                | (228)  |
| Balance as of September 30, 2014        | \$410                                | \$(480)                         | \$46                             | \$ (24)  |

The following table details activity in accumulated other comprehensive income (loss) for the nine-month period ended September 30, 2014:

| (\$ in thousands)                         | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|---|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of December 31, 2013           | \$(639)                              | \$(480)                         | \$46                             | \$ (1,073)   |
| Current period other comprehensive income | 1,049                                | —                               | —                                | 1,049  |
| Balance as of September 30, 2014          | \$410                                | \$(480)                         | \$46                             | \$ (24)  |

The following table details activity in accumulated other comprehensive income (loss) for the three-month period ended September 30, 2013:

| (\$ in thousands)                       | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|---|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of June 30, 2013             | \$(616)                              | \$(668)                         | \$8                              | \$ (1,276)   |
| Current period other comprehensive loss | 139                                  | —                               | —                                | 139  |
| Balance as of September 30, 2013        | \$(477)                              | \$(668)                         | \$8                              | \$ (1,137)   |

The following table details activity in accumulated other comprehensive income (loss) for the nine-month period ended September 30, 2013:

| (\$ in thousands)                       | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|---|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of December 31, 2012         | \$1,834                              | \$(668)                         | \$8                              | \$ 1,174   |
| Current period other comprehensive loss | (2,311)                              | —                               | —                                | (2,311)  |



|                                  |           |           |      |             |
|----------------------------------|-----------|-----------|------|-------------|
| Balance as of September 30, 2013 | \$ (477 ) | \$ (668 ) | \$ 8 | \$ (1,137 ) |
|----------------------------------|-----------|-----------|------|-------------|

## 11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments, whose contract amounts represent credit risk at the indicated periods, were as follows:

| (in thousands)               | September<br>30,<br>2014 | December<br>31, 2013 |
|------------------------------|--------------------------|----------------------|
| Undisbursed loan commitments | \$172,630                | \$172,563            |
| Standby letters of credit    | 2,014                    | 2,489                |
| Commitments to sell loans    | 1,584                    | 3,209                |
|                              | \$176,228                | \$178,261            |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank issues both financial and performance standby letters of credit. The financial standby letters of credit are primarily to guarantee payment to third parties. At September 30, 2014, there were no financial standby letters of credit outstanding. The performance standby letters of credit are typically issued to municipalities as specific performance bonds. At September 30, 2014, there was \$2,014,000 issued in performance standby letters of credit. At September 30, 2014, the Bank has experienced no draws on these letters of credit, resulting in no related liability included on their balance sheet, however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of \$793,000 at September 30, 2014, which is recorded in "interest payable and other liabilities" on the Condensed Consolidated Balance Sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of September 30, 2014, the Company had no off-balance sheet derivatives requiring additional disclosure.

Mortgage loans sold to investors may be sold with servicing rights retained, for which the Company makes only standard legal representations and warranties as to meeting certain underwriting and collateral documentation standards. In the past two years, the number of loans the Company has had to repurchase due to deficiencies in underwriting or loan documentation is not significant. Management believes that any liabilities that may result from such recourse provisions are not significant.

FIRST NORTHERN COMMUNITY BANCORP

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

FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements, which may include forecasts of our financial results and condition, expectations for our operations and business, and our assumptions for those forecasts and expectations. Do not rely unduly on forward-looking statements. Actual results might differ significantly compared to our forecasts and expectations. See Part I, Item 1A. “Risk Factors,” and the other risks described in our 2013 Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q for factors to be considered when reading any forward-looking statements in this filing.

This report and other reports or statements which we may release includes forward-looking statements, which are subject to the “safe harbor” created by section 27A of the Securities Act of 1933, as amended, and section 21E of the Securities Exchange Act of 1934, as amended. We may make forward-looking statements in our Securities and Exchange Commission (SEC) filings, press releases, news articles and when we are speaking on behalf of the Company. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include the words “believe,” “expect,” “target,” “anticipate,” “intend,” “plan,” “seek,” “strive,” “potential,” “project,” or words of similar meaning, or future or conditional verbs such as “will,” “would,” “should,” “could,” “might,” or “may.” These forward-looking statements are intended to provide investors with additional information with which they may assess our future potential. All of these forward-looking statements are based on assumptions about an uncertain future and are based on information available to us at the date of these statements. We do not undertake to update forward-looking statements to reflect facts, circumstances, assumptions or events that occur after the date any forward-looking statements are made.

In this document and in other SEC filings or other public statements, for example we make forward-looking statements relating to the following topics, among others:

- Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position and prospects, and the affect of competition on our business and strategies
  - Our assessment of significant factors and developments that have affected or may affect our results
- Pending and recent legal and regulatory actions, and future legislative and regulatory developments, including the effects of the Dodd-Frank Wall Street Reform and Protection Act (the “Dodd-Frank Act”) and other legislation and governmental measures introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy
  - Regulatory and compliance controls, processes and requirements and their impact on our business
    - The costs and effects of legal or regulatory actions
    - We do not expect draws on performance letters of credit
- Our regulatory capital requirements, including the recently adopted capital rules by the U.S. federal banking agencies

- We do not anticipate paying a cash dividend on our common stock in the foreseeable future
  - Credit quality and provision for credit losses
- Our allowances for credit losses, including the conditions we consider in determining the unallocated allowance and our portfolio credit quality, underwriting standards, and risk grading

- Our assessment of economic conditions and trends and credit cycles and their impact on our business
  - The seasonal nature of our business
- The impact of changes in interest rates and our strategy to manage our interest rate risk profile and the possible effect of increases in residential mortgage interest rates on new originations and refinancing of existing residential mortgage loans.
- Loan portfolio composition and risk grade trends, expected charge offs, portfolio credit quality, our strategy regarding troubled debt restructurings (TDRs), delinquency rates and our underwriting standards
  - Our deposit base including renewal of time deposits
- The impact on our net interest income and net interest margin from the current low-interest rate environment
  - The Company does not anticipate any significant increase or decrease in unrecognized tax benefits
    - Our pension and retirement plan costs
      - Our liquidity position
- Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or changes in accounting principles
  - Expected rates of return, maturities, loss exposure, growth rates, yields and projected results
- The possible impact of the California drought on economic conditions, especially in the agricultural sector.
  - Maintenance of insurance coverage appropriate for our operations
  - Threats to the banking sector and our business due to cybersecurity issues and attacks
  - Descriptions of assumptions underlying or relating to any of the of the foregoing

Readers of this document should not rely on any forward-looking statements, which reflect only our management's belief as of the date of this report. There are numerous risks and uncertainties that could and will cause actual results to differ materially from those discussed in our forward-looking statements. Many of these factors are beyond our ability to control or predict and could have a material adverse effect on our financial condition and results of operations or prospects. Such risks and uncertainties include, but are not limited to those listed in Item 1A "Risk Factors" of Part II, Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I of this Form 10-Q and "Supervision and Regulation" of our 2013 Annual Report on Form 10-K, and in our other reports to the SEC.

## INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire report and any other reports to the Securities and Exchange Commission ("SEC"), together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Our subsidiary, First Northern Bank of Dixon (the "Bank"), is a California state-chartered bank that derives most of its revenues from lending and deposit taking in the Sacramento Valley region of Northern California. Interest rates, business conditions and customer confidence all affect our ability to generate revenues. In addition, the regulatory and compliance environment and competition can present challenges to our ability to generate those revenues.

Significant results and developments during the third quarter and year-to-date 2014 include:

- Net income of \$4.3 million for the nine months ended September 30, 2014, up 2.4% from \$4.2 million earned for the same fiscal period last year.
- Net income available to common shareholders of \$4.2 million for the nine months ended September 30, 2014, up 16.7% from \$3.6 million for the same fiscal period last year.
- Diluted income per share for the nine-month period ended September 30, 2014 was \$0.43, up 16.2% from diluted income per share of \$0.37 in the same period last year.
- Net interest income increased in the nine months ended September 30, 2014 by \$1.6 million, or 7.8%, to \$22.0 million from \$20.4 million in the same period last year. The increase in net interest income was primarily attributable to an increase in interest income on loans and securities. The increase in interest income on loans is primarily due to an increase in average loans, partially offset by a decrease in interest yield. The increase in interest income on securities is primarily due to an increase in interest yield, partially offset by a decrease in average investment securities. Net interest margin decreased from 3.42% for the nine-month period ending September 30, 2013 to 3.33% for the same period ending September 30, 2014.
- Provision for loan losses of \$1.6 million for the nine-month period ended September 30, 2014 compared to a provision for loan losses of \$0.8 million for the same period in 2013.
- Total assets at September 30, 2014 were \$954.1 million, an increase of \$56.4 million, or 6.3%, compared to total assets at December 31, 2013.
- Total net loans at September 30, 2014 (including loans held-for-sale) increased \$18.0 million, or 3.5%, to \$526.1 million compared to December 31, 2013.
- Total investment securities at September 30, 2014 decreased \$29.5 million, or 17.0%, to \$143.8 million compared to December 31, 2013.

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- Total deposits of \$855.8 million at September 30, 2014, represented an increase of \$52.0 million, or 6.5%, compared to December 31, 2013.
- Net income of \$1.6 million for the three months ended September 30, 2014, up 14.3% from \$1.4 million for the same fiscal period last year.
- Net income available to common shareholders of \$1.5 million for the three months ended September 30, 2014, up 25.0% from \$1.2 million for the same fiscal period last year.
- Diluted income per share for the three-month period ended September 30, 2014 was \$0.16, up 33.3% from diluted income per share of \$0.12 in the same fiscal period last year.



## SUMMARY

The Company recorded net income of \$4,273,000 for the nine-month period ended September 30, 2014, representing an increase of \$95,000 from net income of \$4,178,000 for the same period in 2013. The Company recorded net income of \$1,570,000 for the three-month period ended September 30, 2014, representing an increase of \$197,000 from net income of \$1,373,000 for the same period in 2013.

The following tables present a summary of the results for the three-month and nine-month periods ended September 30, 2014 and 2013, and a summary of our financial condition at September 30, 2014 and December 31, 2013:

|  | Three<br>months<br>ended<br>September<br>30, 2014 | Three<br>months<br>ended<br>September<br>30, 2013 | Nine<br>Months ended<br>September<br>30, 2014 | Nine<br>Months ended<br>September<br>30, 2013 |
|--|---|---|---|---|
|--|---|---|---|---|

(in thousands except for per share amounts)

For the Period:

|   |         |         |          |          |
|---|---------|---------|----------|----------|
| Net Income                                  | \$1,570 | \$1,373 | \$ 4,273 | \$ 4,178 |
| Net income Available to Common Shareholders | \$1,537 | \$1,211 | \$ 4,176 | \$ 3,644 |
| Basic Earnings Per Common Share             | \$0.16  | \$0.12  | \$ 0.43  | \$ 0.38  |
| Diluted Earnings Per Common Share           | \$0.16  | \$0.12  | \$ 0.43  | \$ 0.37  |

|  |                       |                      |
|--|-----------------------|----------------------|
|  | September<br>30, 2014 | December<br>31, 2013 |
|--|-----------------------|----------------------|

(in thousands except for ratios)

At Period End:

|  |           |           |   |
|--|-----------|-----------|---|
| Total Assets                                     | \$954,055 | \$897,669 |   |
| Total Loans, Net (including loans held-for-sale) | \$526,054 | \$508,113 |   |
| Total Investment Securities                      | \$143,789 | \$173,269 |   |
| Total Deposits                                   | \$855,778 | \$803,787 |   |
| Loan-To-Deposit Ratio                            | 61.5      | % 63.2    | % |



## FIRST NORTHERN COMMUNITY BANCORP

Distribution of Average Statements of Condition and Analysis of Net Interest Income  
(in thousands, except percentage amounts)

|   | Three months ended<br>September 30, 2014 |          |                |   | Three months ended<br>September 30, 2013 |          |                |   |
|---|--|----------|----------------|---|--|----------|----------------|---|
|   | Average<br>Balance                       | Interest | Yield/<br>Rate |   | Average<br>Balance                       | Interest | Yield/<br>Rate |   |
| Assets  |  |          |                |   |  |          |                |   |
| Interest-earning assets:                              |  |          |                |   |  |          |                |   |
| Loans (1)   | \$517,208                                | \$6,717  | 5.15           | % | \$483,868                                | \$6,466  | 5.30           | % |
| Interest bearing due from banks                       | 205,940                                  | 132      | 0.25           | % | 134,266                                  | 103      | 0.30           | % |
| Investment securities, taxable                        | 148,996                                  | 741      | 1.97           | % | 180,002                                  | 621      | 1.37           | % |
| Investment securities,<br>non-taxable (2)             | 8,919                                    | 85       | 3.78           | % | 9,770                                    | 99       | 4.02           | % |
| Other interest earning assets                         | 3,934                                    | 77       | 7.77           | % | 3,717                                    | 46       | 4.91           | % |
| Total average interest-earning<br>assets              | 884,997                                  | 7,752    | 3.48           | % | 811,623                                  | 7,335    | 3.59           | % |
| Non-interest-earning assets:                          |  |          |                |   |  |          |                |   |
| Cash and due from banks                               | 17,133                                   |          |                |   | 17,033                                   |          |                |   |
| Premises and equipment, net                           | 7,366                                    |          |                |   | 7,593                                    |          |                |   |
| Other real estate owned                               | 367                                      |          |                |   | —  |          |                |   |
| Interest receivable and other<br>assets               | 26,142                                   |          |                |   | 28,880                                   |          |                |   |
| Total average assets                                  | 936,005                                  |          |                |   | 865,129                                  |          |                |   |
| Liabilities and Stockholders' Equity:                 |  |          |                |   |  |          |                |   |
| Interest-bearing liabilities:                         |  |          |                |   |  |          |                |   |
| Interest-bearing transaction                          |  |          |                |   |  |          |                |   |
| deposits  | 218,712                                  | 75       | 0.14           | % | 199,490                                  | 67       | 0.13           | % |
| Savings and MMDA's                                    | 257,585                                  | 142      | 0.22           | % | 227,290                                  | 144      | 0.25           | % |
| Time, under \$100,000                                 | 32,104                                   | 28       | 0.35           | % | 33,866                                   | 32       | 0.37           | % |
| Time, \$100,000 and over                              | 57,363                                   | 67       | 0.46           | % | 54,947                                   | 63       | 0.45           | % |
| FHLB advances and other<br>borrowings                 | —  | —        | —              | % | —  | —        | —              | % |
| Total average interest-bearing<br>liabilities         | 565,764                                  | 312      | 0.22           | % | 515,593                                  | 306      | 0.24           | % |
| Non-interest-bearing liabilities:                     |  |          |                |   |  |          |                |   |
| Non-interest-bearing demand                           |  |          |                |   |  |          |                |   |
| deposits  | 272,697                                  |          |                |   | 257,810                                  |          |                |   |
| Interest payable and other<br>liabilities             | 7,606                                    |          |                |   | 8,488                                    |          |                |   |
| Total liabilities                                     | 846,067                                  |          |                |   | 781,891                                  |          |                |   |
| Total average stockholders'<br>equity                 | 89,938                                   |          |                |   | 83,238                                   |          |                |   |
| Total average liabilities and<br>stockholders' equity | \$936,005                                |          |                |   | \$865,129                                |          |                |   |

|   |         |      |   |         |      |   |
|---|---------|------|---|---------|------|---|
| Net interest income and net interest margin (3) | \$7,440 | 3.34 | % | \$7,029 | 3.44 | % |
|---|---------|------|---|---------|------|---|

(1) Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-

accrued interest thereon is excluded. Loan interest income includes loan fees of approximately \$229 and \$360 for the three months

ended September 30, 2014 and 2013, respectively.

(2) Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.

(3) Net interest margin is computed by dividing net interest income by total average interest-earning assets. For disclosure purposes yield /rates are annualized by dividing the number of days in the reported period by 365 days.

## FIRST NORTHERN COMMUNITY BANCORP

Distribution of Average Statements of Condition and Analysis of Net Interest Income  
(in thousands, except percentage amounts)

|   | Nine Months ended<br>September 30, 2014 |          |                |   | Nine Months ended<br>September 30, 2013 |          |                |   |
|---|---|----------|----------------|---|---|----------|----------------|---|
|   | Average<br>Balance                      | Interest | Yield/<br>Rate |   | Average<br>Balance                      | Interest | Yield/<br>Rate |   |
| Assets  |   |          |                |   |   |          |                |   |
| Interest-earning assets:                              |   |          |                |   |   |          |                |   |
| Loans (1)   | \$509,252                               | \$19,795 | 5.20           | % | \$459,689                               | \$18,671 | 5.43           | % |
| Interest bearing due from banks                       | 202,802                                 | 411      | 0.27           | % | 140,984                                 | 315      | 0.30           | % |
| Investment securities, taxable                        | 155,383                                 | 2,232    | 1.92           | % | 183,083                                 | 1,961    | 1.43           | % |
| Investment securities,<br>non-taxable (2)             | 9,465                                   | 282      | 3.98           | % | 9,972                                   | 298      | 4.00           | % |
| Other interest earning assets                         | 3,846                                   | 205      | 7.13           | % | 3,671                                   | 106      | 3.86           | % |
| Total average interest-earning<br>assets              | 880,748                                 | 22,925   | 3.48           | % | 797,399                                 | 21,351   | 3.58           | % |
| Non-interest-earning assets:                          |   |          |                |   |   |          |                |   |
| Cash and due from banks                               | 16,662                                  |          |                |   | 16,458                                  |          |                |   |
| Premises and equipment, net                           | 7,402                                   |          |                |   | 7,707                                   |          |                |   |
| Other real estate owned                               | 211                                     |          |                |   | 535                                     |          |                |   |
| Interest receivable and other<br>assets               | 26,495                                  |          |                |   | 28,848                                  |          |                |   |
| Total average assets                                  | 931,518                                 |          |                |   | 850,947                                 |          |                |   |
| Liabilities and Stockholders' Equity:                 |   |          |                |   |   |          |                |   |
| Interest-bearing liabilities:                         |   |          |                |   |   |          |                |   |
| Interest-bearing transaction                          |   |          |                |   |   |          |                |   |
| deposits  | 215,690                                 | 223      | 0.14           | % | 194,082                                 | 195      | 0.13           | % |
| Savings and MMDA's                                    | 255,533                                 | 467      | 0.24           | % | 224,880                                 | 447      | 0.27           | % |
| Time, under \$100,000                                 | 32,794                                  | 85       | 0.35           | % | 35,137                                  | 104      | 0.40           | % |
| Time, \$100,000 and over                              | 58,279                                  | 198      | 0.45           | % | 54,859                                  | 206      | 0.50           | % |
| FHLB advances and other<br>borrowings                 | 2                                       | —        | —              | % | 1                                       | —        | —              | % |
| Total average interest-bearing<br>liabilities         | 562,298                                 | 973      | 0.23           | % | 508,959                                 | 952      | 0.25           | % |
| Non-interest-bearing liabilities:                     |   |          |                |   |   |          |                |   |
| Non-interest-bearing demand                           |   |          |                |   |   |          |                |   |
| deposits  | 273,332                                 |          |                |   | 249,351                                 |          |                |   |
| Interest payable and other<br>liabilities             | 7,677                                   |          |                |   | 7,930                                   |          |                |   |
| Total liabilities                                     | 843,307                                 |          |                |   | 766,240                                 |          |                |   |
| Total average stockholders'<br>equity                 | 88,211                                  |          |                |   | 84,707                                  |          |                |   |
| Total average liabilities and<br>stockholders' equity | \$931,518                               |          |                |   | \$850,947                               |          |                |   |

|   |          |      |   |          |      |   |
|---|----------|------|---|----------|------|---|
| Net interest income and net interest margin (3) | \$21,952 | 3.33 | % | \$20,399 | 3.42 | % |
|---|----------|------|---|----------|------|---|

(1) Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-

accrued interest thereon is excluded. Loan interest income includes loan fees of approximately \$706 and \$1,021 for the nine months

ended September 30, 2014 and 2013, respectively.

(2) Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.

(3) Net interest margin is computed by dividing net interest income by total average interest-earning assets. For disclosure purposes yield /rates are annualized by dividing the number of days in the reported period by 365 days.

## CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a \$69,374,000 increase in cash and cash equivalents, a \$29,480,000 decrease in investment securities available-for-sale, a \$17,946,000 increase in net loans held-for-investment, a \$5,000 decrease in loans held-for-sale and a \$1,544,000 decrease in interest receivable and other assets from December 31, 2013 to September 30, 2014. The increase in cash and cash equivalents was due to an increase in interest bearing due from Federal Reserve Bank accounts, which was the result of a management decision to not reinvest in longer term bonds. The decrease in investment securities available-for-sale was primarily the result of sales, calls and maturities of agency bonds and municipal securities, and amortization on mortgage backed securities, partially offset by the purchase of U.S. government agencies, municipal securities and mortgage backed securities. The increase in loans held-for-investment was due to increases in the following loan categories as a result of increased loan demand: commercial, commercial real estate and agriculture. The increase in loans held-for-investment was partially offset by decreases in the following loan categories: residential mortgage, residential construction and consumer. The decrease in loans held-for-sale was due to timing of sales of loans held-for-sale. The decrease in interest receivable and other assets was mainly due to a decrease in accrued income taxes receivable.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of \$51,991,000 from December 31, 2013 to September 30, 2014. The increase in deposits was due to increases in interest-bearing transaction deposits, savings accounts, money market accounts, and time deposits, which were partially offset by decreases in demand accounts.

## CHANGES IN RESULTS OF OPERATIONS

### Interest Income

The Federal Open Market Committee made no changes to the Federal Funds rate during the nine-month period ended September 30, 2014.

Interest income on loans for the nine-month period ended September 30, 2014 was up 6.0% from the same period in 2013, increasing from \$18,671,000 to \$19,795,000 and was up 3.9% for the three-month period ended September 30, 2014 over the same period in 2013, increasing from \$6,466,000 to \$6,717,000. The increase in interest income on loans for the nine-month period ended September 30, 2014 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 23 basis point decrease in loan yields. The increase in interest income on loans for the three-month period ended September 30, 2014 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 15 basis point decrease in loan yields. The decrease in loan yields was primarily due to the origination of new loans and the repricing of existing loans at lower rates.

Interest income on investment securities available-for-sale for the nine-month period ended September 30, 2014 was up 11.3% from the same period in 2013, increasing from \$2,259,000 to \$2,514,000 and was up 14.7% for the three-month period ended September 30, 2014 over the same period in 2013, increasing from \$720,000 to \$826,000. The increase in interest income on investment securities for the nine-month and three-month periods ended September 30, 2014 as compared to the same period a year ago was primarily due to an increase in the yields of investment securities of 47 and 57 basis points, respectively, which were partially offset by an decrease in average investment securities. The increase in investment securities yields was primarily due to slower pre-payments resulting in slower amortization of premiums on mortgage backed securities.

Interest income on interest-bearing due from banks for the nine-month period ended September 30, 2014 was up 30.5% from the same period in 2013, increasing from \$315,000 to \$411,000 and was up 28.2% for the three-month period ended September 30, 2014 over the same period in 2013, increasing from \$103,000 to \$132,000. The increase in interest income on interest-bearing due from banks for the nine-month period ended September 30, 2014 as compared to the same period a year ago was due to an increase in the average interest-bearing due from banks balance outstanding, partially offset by a 3 basis point decrease in interest bearing due from banks yield. The increase in interest income on interest-bearing due from banks for the three-month period ended September 30, 2014 as compared to the same period a year ago was due to an increase in average interest-bearing due from banks, partially offset by a 5 basis point decrease in interest bearing due from banks yield.

The Company had no Federal Funds sold balances during the nine-month periods ended September 30, 2014 and September 30, 2013.



### Interest Expense

Interest expense on deposits and other borrowings for the nine-month period ended September 30, 2014 was up 2.2% from the same period in 2013, increasing from \$952,000 to \$973,000 and was up 2.0% for the for the three-month period ended September 30, 2014 over the same period in 2013, from \$306,000 to \$312,000. The increase in interest expense during the nine-month period ended September 30, 2014 was due to an increase in the average balance of interest-bearing liabilities, which was partially offset by 2 basis point decrease in the Company's average cost of funds. The increase in interest expense during the three-month period ended September 30, 2014 was due to an increase in the average balance of interest-bearing liabilities, which was partially offset by 2 basis point decrease in the Company's average cost of funds. The Company had no FHLB advances and related interest expense during the nine-month periods ended September 30, 2014 and September 30, 2013.

### Provision for Loan Losses

There was a provision for loan losses of \$1,600,000 for the nine-month period ended September 30, 2014 compared to a provision for loan losses of \$800,000 for the same period in 2013. There was a provision for loan losses of \$400,000 for the three-month period ended September 30, 2014 compared to no provision for loan losses for the same period in 2013. The allowance for loan losses was approximately \$8,402,000, or 1.58% of total loans, at September 30, 2014 compared to \$9,353,000, or 1.81% of total loans, at December 31, 2013. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

The increase in the provision for loan losses during the three-month and nine-month periods in 2014 was primarily due to increased net charge-offs compared to the same periods in 2013.

### Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the nine-month periods ended September 30, 2014 and September 30, 2013.

The provision for unfunded lending commitment losses is included in non-interest expense in the Condensed Consolidated Statements of Income.

## Other Operating Income

Other operating income was down 23.7% for the nine-month period ended September 30, 2014 from the same period in 2013, decreasing from \$7,443,000 to \$5,680,000.

This decrease was primarily due to decreases in service charges on deposit accounts, gains on sales of loans held for sale, investment and brokerage services income, mortgage brokerage income, and loan servicing income, which was partially offset by increases in signature based transaction fees and ATM fees. The decrease in service charges on deposit accounts was primarily due to a decrease in the volume of service charges on checking accounts. The decrease in gains on sales of loans held-for-sale was due to an increase in market interest rates and a corresponding decrease in sales volume. The decrease in investment and brokerage services income and mortgage brokerage income was due to a decrease in the demand for those services. The decrease in loan servicing income was primarily due to a decrease in mortgage servicing assets recorded and the prior year reversal of impairment expense, which was partially offset by a decrease in mortgage servicing amortization expense. The increase in signature based transaction fee income was primarily due to an increase in rates charged and volume of transactions. The increase in ATM fees was primarily due to an increase in volume of transactions and ATM fees charged.

Other operating income was down 7.4% for the three-month period ended September 30, 2014 from the same period in 2013, decreasing from \$2,273,000 to \$2,104,000.

This decrease was primarily due to decreases in investment and brokerage services income and loan servicing income, which was partially offset by increases in ATM fees and signature based transactions fees. The decrease in investment and brokerage services income and mortgage brokerage income was due to a decrease in the demand for those services. The decrease in loan servicing income was primarily due to a decrease in mortgage servicing assets recorded and the prior year reversal of impairment expense, which was partially offset by a decrease in mortgage servicing amortization expense. The increase in signature based transaction fee income was primarily due to an increase in rates charged and volume of transactions. The increase in ATM fees was primarily due to an increase in volume of transactions and ATM fees charged.

#### Other Operating Expenses

Total other operating expenses were down 3.8% for the nine-month period ended September 30, 2014 from the same period in 2013, decreasing from \$20,530,000 to \$19,745,000.

The decrease was primarily due to decreases in salaries and employee benefits and occupancy and equipment expense, which was partially offset by increases in other expenses. The decrease in salaries and employee benefits was primarily due to a decrease in commissions, contingent compensation, and profit sharing contributions. Commissions decreased as a result of decreased number of mortgage origination transactions and a reduction in investment and brokerage assets. The decrease in salaries and employee benefit expense was partially offset by an increase in regular salaries expense, which were due to routine merit increases. The decrease in occupancy and equipment expense was primarily due to decreases in rentals on solar equipment and depreciation expense. The increase in other expenses was primarily due to increases in sundry losses, loan collection expense, loan origination expense, and interchange fees, which was partially offset by a decrease in consulting fees.

Total other operating expenses were down 1.9% for the three-month period ended September 30, 2014 from the same period in 2013, decreasing from \$6,925,000 to \$6,792,000.

The decrease was primarily due to decreases in salaries and employee benefits expense, which was partially offset by increases in other expenses. The decrease in salaries and employee benefits was primarily due to a decrease in commissions, contingent compensation, and profit sharing contributions. Commissions decreased as a result of decreased number of mortgage origination transactions and a reduction in investment and brokerage assets. The decrease in salaries and employee benefit expense was partially offset by an increase in regular salaries expense, which were due to routine merit increases. The increase in other expenses was primarily due to increases in sundry losses, loan collection expense, loan origination expense and interchange fees.

The following table sets forth other miscellaneous operating expenses by category for the three-month and nine-month periods ended September 30, 2014 and 2013.

|   | (in thousands)                                       |  |   |   |
|---|--|--|---|---|
|   | Three<br>months<br>ended<br>September<br>30,<br>2014 | Three<br>months<br>ended<br>September<br>30,<br>2013 | Nine<br>months<br>ended<br>September<br>30,<br>2014 | Nine<br>months<br>ended<br>September<br>30,<br>2013 |
| Other miscellaneous operating expenses              |  |  |   |   |
| FDIC assessments                                    | \$ 155   | \$ 145   | \$ 445  | \$ 445  |
| Contributions                                       | 34   | 35   | 96  | 85  |
| Legal fees  | 34   | 37   | 106   | 119   |
| Accounting and audit fees                           | 73   | 67   | 249   | 235   |
| Consulting fees                                     | 114  | 121  | 391   | 510   |
| Postage expense                                     | 61   | 56   | 222   | 229   |
| Telephone expense                                   | 35   | 32   | 105   | 126   |
| Public relations                                    | 56   | 61   | 173   | 157   |
| Training expense                                    | 44   | 32   | 107   | 96  |
| Loan origination expense                            | 169  | 91   | 428   | 350   |
| Computer software depreciation                      | 15   | 29   | 52  | 89  |
| Sundry losses                                       | 34   | —  | 114   | 17  |
| Loan collection expense                             | 76   | 24   | 223   | 56  |
| Other miscellaneous expense                         | 401  | 390  | 1,169   | 1,123   |
| <b>Total other miscellaneous operating expenses</b> | <b>\$ 1,301</b>                                      | <b>\$ 1,120</b>                                      | <b>\$ 3,880</b>                                     | <b>\$ 3,637</b>                                     |

## Income Taxes

The Company's tax rate, the Company's income or loss before taxes and the amount of tax relief provided by non-taxable earnings primarily affect the Company's provision for income taxes.

In the nine months ended September 30, 2014, the Company's expense for income taxes decreased \$320,000 from the same period last year, from \$2,334,000 to \$2,014,000.

In the three months ended September 30, 2014, the Company's provision for income taxes decreased \$222,000 from the same period last year, from \$1,004,000 to \$782,000.

The decrease in provision for income taxes for the period presented is primarily attributable to the respective level of earnings combined with the interim effective tax rate and the incidence of allowable deductions, in particular non-taxable municipal bond income, tax credits generated from low-income housing investments, solar tax credits, and excludable interest income.

## Off-Balance Sheet Commitments

The following table shows the distribution of the Company's undisbursed loan commitments at the dates indicated.

|                              | (in thousands)        |                      |
|------------------------------|-----------------------|----------------------|
|                              | September<br>30, 2014 | December<br>31, 2013 |
| Undisbursed loan commitments | \$172,630             | \$172,563            |
| Standby letters of credit    | 2,014                 | 2,489                |
| Commitments to sell loans    | 1,584                 | 3,209                |
|                              | \$176,228             | \$178,261            |

The reserve for unfunded lending commitments amounted to \$793,000 at September 30, 2014 and December 31, 2013, respectively. The reserve for unfunded lending commitments is included in other liabilities on the Condensed Consolidated Balance Sheets.

## Asset Quality

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies. The federal bank regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes:

- **Substandard Assets** – A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful Assets** – An asset 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.

Other Real Estate Owned and loans rated Substandard and Doubtful are deemed "classified assets". This category, which includes both performing and non-performing assets, receives an elevated level of attention regarding collection.

The following tables summarize the Company's non-accrual loans net of guarantees of the State of California and U.S. Government by loan category at September 30, 2014 and December 31, 2013:

|                                | At September 30, 2014 |              |                | At December 31, 2013 |              |                |
|--------------------------------|-----------------------|--------------|----------------|----------------------|--------------|----------------|
|                                | Gross                 | Guaranteed   | Net            | Gross                | Guaranteed   | Net            |
| (dollars in thousands)         |                       |              |                |                      |              |                |
| Residential mortgage           | \$2,039               | \$—          | \$2,039        | \$2,166              | \$—          | \$2,166        |
| Residential construction       | 76                    | —            | 76             | 93                   | —            | 93             |
| Commercial real estate         | 1,648                 | 77           | 1,571          | 2,607                | 200          | 2,407          |
| Agriculture                    | —                     | —            | —              | 1,590                | —            | 1,590          |
| Commercial                     | 2,198                 | 97           | 2,101          | 2,609                | 202          | 2,407          |
| Consumer                       | 675                   | 18           | 657            | 505                  | 23           | 482            |
| <b>Total non-accrual loans</b> | <b>\$6,636</b>        | <b>\$192</b> | <b>\$6,444</b> | <b>\$9,570</b>       | <b>\$425</b> | <b>\$9,145</b> |

It is generally the Company's policy to discontinue interest accruals once a loan is past due for a period of 90 days as to interest or principal payments. When a loan is placed on non-accrual, interest accruals cease and uncollected accrued interest is reversed and charged against current income. Payments received on non-accrual loans are applied against principal. A loan may only be restored to an accruing basis when it again becomes well secured and in the process of collection or all past due amounts have been collected.

Non-accrual loans amounted to \$6,636,000 at September 30, 2014 and were comprised of seven residential mortgage loans totaling \$2,039,000, two residential construction loans totaling \$76,000, seven commercial real estate loans totaling \$1,648,000, seven commercial loans totaling \$2,198,000 and seven consumer loans totaling \$675,000. Non-accrual loans amounted to \$9,570,000 at December 31, 2013 and were comprised of seven residential mortgage loans totaling \$2,166,000, two residential construction loans totaling \$93,000, nine commercial real estate

loans totaling \$2,607,000, three agricultural loans totaling \$1,590,000, nine commercial loans totaling \$2,609,000 and five consumer loans totaling \$505,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral.

The five largest non-accrual loans as of September 30, 2014, totaled approximately \$4,119,000 or 62.1% of total non-accrual loans and consisted of one commercial real estate loan totaling \$1,056,000, supported by commercial properties located within the Company's market area, two residential mortgage loans totaling \$1,243,000, supported by residential properties located within the Company's market area and two commercial and industrial loan totaling \$1,820,000, supported by the business assets of the borrower. The collateral securing these loans is generally appraised every six months.

In comparison, the five largest non-accrual loans as of December 31, 2013, totaled approximately \$4,587,000 or 48% of total non-accrual loans and consisted of two residential mortgage loans totaling \$1,323,000, supported by residential property located within the Company's market area, one commercial real estate loan totaling \$1,099,000, supported by commercial properties located within the Company's market area, one agricultural loan totaling \$626,000, supported by real property located within the Company's market area, and one commercial and industrial loan totaling \$1,539,000, supported by the business assets of the borrower. The collateral securing all of these loans is generally appraised every six months.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Non-performing impaired loans are non-accrual loans and loans that are 90 days or more past due and still accruing. Total non-performing impaired loans at September 30, 2014 and December 31, 2013 consisting of loans on non-accrual status totaled \$6,636,000 and \$9,570,000, respectively. A restructuring of a loan can constitute a troubled debt restructuring if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A loan that is restructured in a troubled debt restructuring is considered an impaired loan. Performing impaired loans, which consisted of loans modified as troubled debt restructurings, totaled \$6,703,000 at September 30, 2014. At December 31, 2013, performing impaired loans totaled \$9,187,000, which consisted of loans modified as troubled debt restructurings totaling \$6,750,000 and other impaired loans totaling \$2,437,000. The Company expects to collect all principal and interest due from performing impaired loans. These loans are not on non-accrual status. The majority of the non-performing impaired loans, in management's opinion, were adequately collateralized based on recently obtained appraised property values or were guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

As the following table illustrates, total non-performing assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased \$2,701,000, or 29.5% to \$6,444,000 during the first nine months of 2014. Non-performing assets, net of guarantees, represented 0.7% of total assets at September 30, 2014.

|   | At September 30, 2014 |            |         | At December 31, 2013 |            |         |
|---|-----------------------|------------|---------|----------------------|------------|---------|
|   | Gross                 | Guaranteed | Net     | Gross                | Guaranteed | Net     |
| (dollars in thousands)                    |                       |            |         |                      |            |         |
| Non-accrual loans                         | \$6,636               | \$192      | \$6,444 | \$9,570              | \$425      | \$9,145 |
| Loans 90 days past due and still accruing | 147                   | —          | 147     | —                    | —          | —       |
| Total non-performing loans                | 6,783                 | 192        | 6,591   | 9,570                | 425        | 9,145   |
| Other real estate owned                   | —                     | —          | —       | —                    | —          | —       |
| Total non-performing assets               | 6,783                 | 192        | 6,591   | 9,570                | 425        | 9,145   |



|   |       |   |       |   |
|---|-------|---|-------|---|
| Non-performing loans to total loans                         | 1.2   | % | 1.8   | % |
| Non-performing assets to total assets                       | 0.7   | % | 1.0   | % |
| Allowance for loan and lease losses to non-performing loans | 130.4 | % | 102.3 | % |

The Company had two consumer loans totaling \$147,000 that were 90 days or more past due and still accruing at September 30, 2014. The Company had no loans 90 days or more past due and still accruing at December 31, 2013.

Other real estate owned (“OREO”) consists of property that the Company has acquired by deed in lieu of foreclosure or through foreclosure proceedings, and property that the Company does not hold title to but is in actual control of, known as in-substance foreclosure. The estimated fair value of the property is determined prior to transferring the balance to OREO. The balance transferred to OREO is the estimated fair value of the property less estimated cost to sell. Impairment may be deemed necessary to bring the book value of the loan equal to the appraised value. Appraisals or loan officer evaluations are then conducted periodically thereafter charging any additional impairment to the appropriate expense account. OREO amounted to \$0 as of September 30, 2014 and December 31, 2013.

## Allowance for Loan Losses

The Company's Allowance for Loan Losses is maintained at a level believed by management to be adequate to provide for loan losses that can be reasonably anticipated. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. The Company contracts with vendors for credit reviews of the loan portfolio as well as considers current economic conditions, loan loss experience, and other factors in determining the adequacy of the reserve balance. The allowance for loan losses is based on estimates, and actual losses may vary from current estimates.

The following table summarizes the Allowance for Loan Losses of the Company during the nine-month periods ended September 30, 2014 and 2013, and for the year ended December 31, 2013:

Analysis of the Allowance for Loan Losses  
(Amounts in thousands, except percentage amounts)

|   | Nine Months ended<br>September 30, |          | Year ended<br>December<br>31, |
|---|------------------------------------|----------|-------------------------------|
|   | 2014                               | 2013     | 2013                          |
| Balance at beginning of period  | \$9,353                            | \$8,554  | \$8,554                       |
| Provision for loan losses   | 1,600                              | 800      | 1,200                         |
| Loans charged-off:  |                                    |          |                               |
| Commercial  | (2,288 )                           | (113 )   | (168 )                        |
| Commercial Real Estate  | (69 )                              | (3 )     | (17 )                         |
| Agriculture   | —                                  | (1 )     | (1 )                          |
| Residential Mortgage  | —                                  | (333 )   | (333 )                        |
| Residential Construction  | —                                  | (127 )   | (127 )                        |
| Consumer  | (378 )                             | (491 )   | (572 )                        |
| Total charged-off   | (2,735 )                           | (1,068 ) | (1,218 )                      |
| Recoveries:   |                                    |          |                               |
| Commercial  | 46                                 | 149      | 377                           |
| Commercial Real Estate  | —                                  | 51       | 51                            |
| Agriculture   | —                                  | 3        | 3                             |
| Residential Mortgage  | —                                  | 157      | 157                           |
| Residential Construction  | 45                                 | 44       | 45                            |
| Consumer  | 93                                 | 102      | 184                           |
| Total recoveries  | 184                                | 506      | 817                           |
| Net charge-offs   | (2,551 )                           | (562 )   | (401 )                        |
| Balance at end of period  | \$8,402                            | \$8,792  | \$9,353                       |
| Ratio of net charge-offs to average loans outstanding<br>during the period (annualized) | (0.66 %)                           | (0.16 %) | (0.09 %)                      |
| Allowance for loan losses<br>To total loans at the end of the period                    | 1.58 %                             | 1.74 %   | 1.81 %                        |

|   |       |   |       |   |       |   |
|---|-------|---|-------|---|-------|---|
| To non-performing loans, net of guarantees at the end of the period | 130.4 | % | 127.3 | % | 102.3 | % |
|---|-------|---|-------|---|-------|---|

## Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2014, the Company had the following deposit mix: 31.9% in savings and MMDA deposits, 10.5% in time deposits, 25.5% in interest-bearing transaction deposits and 32.1% in non-interest-bearing transaction deposits. At December 31, 2013, the Company had the following deposit mix: 28.8% in savings and MMDA deposits, 11.1% in time deposits, 25.9% in interest-bearing transaction deposits and 34.2% in non-interest-bearing transaction deposits. Non-interest-bearing transaction deposits increase the Company's net interest income by lowering its cost of funds.

The Company obtains deposits primarily from the communities it serves. The Company believes that no material portion of its deposits has been obtained from or is dependent on any one person or industry. The Company accepts deposits in excess of \$100,000 from customers. These deposits are priced to remain competitive.

Maturities of time certificates of deposits of \$100,000 or more outstanding at September 30, 2014 and December 31, 2013 are summarized as follows:

|                             | (in thousands)        |                      |
|-----------------------------|-----------------------|----------------------|
|                             | September<br>30, 2014 | December<br>31, 2013 |
| Three months or less        | \$16,965              | \$14,534             |
| Over three to twelve months | 27,388                | 29,231               |
| Over twelve months          | 13,428                | 12,354               |
| Total                       | \$57,781              | \$56,119             |

The increase in time certificates of deposit (CD's) of \$100,000 or more is primarily attributable to additions of time deposits, which was partially offset by the maturities of time deposits.

## Liquidity and Capital Resources

In order to serve our market area, the Company must maintain adequate liquidity and adequate capital. Liquidity is measured by various ratios, in management's opinion, the most common being the ratio of net loans to deposits (including loans held-for-sale). This ratio was 61.5% on September 30, 2014. In addition, on September 30, 2014, the Company had the following short-term investments (based on remaining maturity and/or next repricing date): \$957,000 in securities due within one year or less; and \$34,880,000 in securities due in one to five years.

To meet unanticipated funding requirements, the Company maintains short-term unsecured lines of credit with other banks totaling \$57,000,000 at September 30, 2014. Additionally, the Company has a line of credit with the FHLB, with a borrowing capacity at September 30, 2014 of \$191,994,000; credit availability is subject to certain collateral requirements.

The Company's primary source of liquidity on a stand-alone basis is dividends from the Bank. Dividends from the Bank are subject to regulatory restrictions.

As of September 30, 2014, the Bank's capital ratios exceeded applicable regulatory requirements. The following table presents the capital ratios for the Bank, compared to the regulatory standards for well-capitalized depository institutions, as of September 30, 2014.

(amounts in thousands except percentage amounts)

|                   | Actual   |       |   | Well Capitalized Ratio Requirement |   |
|-------------------|----------|-------|---|------------------------------------|---|
|                   | Capital  | Ratio |   |                                    |   |
| Leverage          | \$86,289 | 9.22  | % | 5.0                                | % |
| Tier 1 Risk-Based | \$86,289 | 15.16 | % | 6.0                                | % |
| Total Risk-Based  | \$93,430 | 16.41 | % | 10.0                               | % |

In July 2013, the Federal Reserve Board and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations and to conform this framework to the Basel Committee's current international regulatory capital accord (Basel III). These rules replaced the federal banking agencies' general risk-based capital rules, advanced approaches rule, market-risk rule, and leverage rules, in accordance with certain transition provisions. The Bank will become subject to the new rules on January 1, 2015. The new rules implement higher minimum capital requirements, include a new common equity Tier 1 capital requirement, and establish criteria that instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. When fully phased in, the final rules will provide for increased minimum capital ratios as follows: (a) a common equity Tier 1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (which is an increase from 4.0%); (c) a total capital ratio of 8%; and (d) a Tier 1 leverage ratio to average consolidated assets of 4%. Under the new rules, in order to avoid certain limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk based capital requirements (equal to 2.5% of total risk-weighted assets). The phase-in of the capital conservation buffer will begin January 1, 2016, and be completed by January 1, 2019. The new rules also provide for various adjustments and deductions to the definitions of regulatory capital that will phase in through December 31, 2017. We are currently evaluating the impact of these changes on our future regulatory capital position.

### ITEM 3. – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company believes that there have been no material changes in the quantitative and qualitative disclosures about market risk as of September 30, 2014, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, which are incorporated by reference herein.

### ITEM 4. – CONTROLS AND PROCEDURES

(a) We maintain "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information 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. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) have concluded that the design and operation of our disclosure controls and procedures are effective as of September 30, 2014. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended September 30, 2014, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II – OTHER INFORMATION

### ITEM 1. – LEGAL PROCEEDINGS

Neither the Company nor the Bank is a party to any material pending legal proceeding, nor is any of their property the subject of any material pending legal proceeding, except ordinary routine litigation arising in the ordinary course of the Bank's business and incidental to its business, none of which is expected to have a material adverse impact upon the Company's or the Bank's business, financial position or results of operations.

### ITEM 1A. – RISK FACTORS

For a discussion of risk factors relating to our business, please refer to Part I, Item 1A of our 2013 Form 10-K, which is incorporated by reference herein, and to the following:

The Bank is Subject to Lending Risks of Loss and Repayment Associated with Commercial Banking Activities

The Bank's business strategy is to focus on commercial business loans (which includes agricultural loans), construction loans, and commercial and multi-family real estate loans. The principal factors affecting the Bank's risk

of loss in connection with commercial business loans include the borrower's ability to manage its business affairs and cash flows, general economic conditions and, with respect to agricultural loans, weather and climate conditions. California continues to experience a severe drought. If the drought significantly harms the business of our customers, particularly in the agricultural sector, the credit quality of our loans to these customers could decline as a specific result of the drought. Loans secured by commercial real estate are generally larger and involve a greater degree of credit and transaction risk than residential mortgage (one to four family) loans. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on successful operation or management of the underlying properties, repayment of such loans may be dependent on factors other than the prevailing conditions in the real estate market or the economy. Real estate construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction or development compared to the estimated cost (including interest) of construction. If the estimate of value proves to be inaccurate, the Bank may be confronted with a project which, when completed, has a value which is insufficient to assure full repayment of the construction loan.



### The Bank's Dependence on Real Estate Lending Increases Our Risk of Losses

At December 31, 2013, approximately 73% of the Bank's loans (excluding loans held-for-sale) were secured by real estate. The value of the Bank's real estate collateral has been, and could in the future continue to be, adversely affected by the economic recession and resulting adverse impact on the real estate market in Northern California.

The Bank's primary lending focus has historically been commercial (including agricultural), construction, and real estate mortgage. At December 31, 2013, real estate mortgage (excluding loans held-for-sale) and construction loans comprised approximately 70% and 2%, respectively, of the total loans in the Bank's portfolio. At December 31, 2013, all of the Bank's real estate mortgage and construction loans and approximately 2% of its commercial loans were secured fully or in part by deeds of trust on underlying real estate. The Company's dependence on real estate increases the risk of loss in both the Bank's loan portfolio and its holdings of other real estate owned if economic conditions in Northern California further deteriorate in the future. Further deterioration of the real estate market in Northern California would have a material adverse effect on the Company's business, financial condition, and results of operations. As noted previously, the severe drought being experienced by California could have an adverse impact on the credit quality of our real estate lending portfolio, particularly in the agricultural sector.

In addition, on January 10, 2013, the CFPB issued an Ability-to-Repay rule that all newly originated residential mortgages must meet, effective January 10, 2014. The Ability-to-Repay rule establishes guidelines that the lender must follow when reviewing a borrower's credit and prohibits some mortgage features. Lenders will be presumed to have met the Ability-to-Repay rule by issuing Qualified Mortgages, a more stringent standard. The majority of the residential mortgages that the Bank currently originates and holds in its mortgage loan portfolio do not meet the Qualified Mortgage criteria but are believed to satisfy the Ability-to-Pay rule. The mortgage loans originated by the Bank with the intent to sell them to Freddie Mac do meet the Qualified Mortgage criteria. The CFPB has also issued a ruling providing for simplified disclosure forms for mortgage transactions, which will be required to be given to consumers for mortgage applications received on or after August 1, 2015. The Ability-to-Repay rule, simplified disclosure forms, and a number of amendments to the rules currently under consideration by the CFPB, could have an adverse impact on our residential mortgage lending business.

### Adverse California Economic Conditions Could Adversely Affect the Bank's Business

The Bank's operations and a substantial majority of the Bank's assets and deposits are generated and concentrated primarily in Northern California, particularly the counties of Placer, Sacramento, Solano and Yolo, and are likely to remain so for the foreseeable future. At December 31, 2013, approximately 73% of the Bank's loan portfolio (excluding loans held-for-sale) consisted of real estate-related loans, all of which were secured by collateral located in Northern California. As a result, a further downturn in the economic conditions in Northern California may cause the Bank to incur losses associated with high default rates and decreased collateral values in its loan portfolio. Economic conditions in California are subject to various uncertainties at this time, including the significant deterioration in the California real estate market and housing industry. As previously mentioned, the severe drought in California, could have an adverse impact on economic conditions in California, particularly in the agricultural sector.

### The Bank is Subject to Interest Rate Risk

The income of the Bank depends to a great extent on “interest rate differentials” and the resulting net interest margins (i.e., the difference between the interest rates earned on the Bank’s interest-earning assets such as loans and investment securities, and the interest rates paid on the Bank’s interest-bearing liabilities such as deposits and borrowings). These rates are highly sensitive to many factors, which are beyond the Bank’s control, including, but not limited to, general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board (the “FRB”). The Bank is generally adversely affected by declining interest rates. For the past several years, in response to the financial crisis which began in 2008 and the ensuing recession, the FRB has pursued a variety of monetary measures aimed at sustaining a very low interest rate environment in the U.S. in order to stimulate economic growth, including purchases of long-term U.S. Treasury and federal agency backed securities and maintaining a very low target range for the federal funds rate.

During the first quarter of 2014, in light of improving conditions in the U.S. labor markets, the Federal Reserve began to reduce the rate of its purchases of long-term U.S. Treasury and agency securities. In late October 2014, the Federal Reserve announced that, in view of the substantial improvement in the outlook for the labor market, it had determined to end its asset purchase program by the end of that month. It also indicated that it would continue its existing policy of reinvesting principal payments from its holdings of agency debt and mortgage-backed securities in agency mortgage-backed securities and of rolling over Treasury securities at auction in order to keep its holdings of longer-term securities at sizeable levels to help maintain accommodative financial conditions. The Federal Reserve further indicated that it expects to maintain the current very low target range for the federal funds rate for some time while it assesses progress toward its objectives of maximum employment and 2 percent inflation and that even after employment and inflation are near its objectives, economic conditions may warrant for some time keeping the target federal funds rate below longer-term normal levels. We cannot predict with any certainty the time during which, nor the extent to which, these Federal Reserve policies will continue. It is also unclear when the Federal Reserve will begin to unwind its asset holdings, as well as the pace at which it may do so. However, as the Federal Reserve unwinds its position, it is expected that excess reserves will be drained from the banking system, which will decrease the overall level of deposits in the system. This could lead to a decline in deposits at some institutions and to increased price competition for stable deposits, which could hamper the improvement in net interest margins that banks are anticipating from rising rates.

Changes in the relationship between short-term and long-term market interest rates or between different interest rate indices can also impact our interest rate differential, possibly resulting in a decrease in our interest income relative to interest expense. In addition, changes in monetary policy, including changes in interest rates, influence the origination of loans, the purchase of investments and the generation of deposits and affect the rates received on loans and investment securities and paid on deposits, which could have a material adverse effect on the Company’s business, financial condition, and results of operations. Increases in long-term residential mortgage interest rates can be expected to decrease the pace of new mortgage loan originations and the pace of refinancing of existing residential mortgage loans.

ITEM 2. – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. – DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. – MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. – OTHER INFORMATION

None.

ITEM 6. – EXHIBITS

Exhibit  
Number

Description of Document

|       |  |
|-------|--|
| 31.1  | Rule 13a — 14(a) Certification of Chief Executive Officer  |
| 31.2  | Rule 13a — 14(a) Certification of Chief Financial Officer  |
| 32.1* | Statement of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)  |
| 32.2* | Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)  |
| 101   | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2014, is formatted in XBRL interactive data files: (i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Comprehensive (Loss) Income (iv) Condensed Consolidated Statement of Stockholders' Equity; (v) Condensed Consolidated Statements of Cash Flows; and (vi) Notes to Condensed Consolidated Financial Statements. |

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\* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed "filed" for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act.

SIGNATURES

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

FIRST NORTHERN COMMUNITY BANCORP

Date: November 6, 2014 By: /s/ Jeremiah Z. Smith

Jeremiah Z. Smith, Senior Executive Vice President /Chief  
Operating Officer and Chief Financial Officer  
(Principal Financial Officer and Duly Authorized Officer)