

FIRST NORTHERN COMMUNITY BANCORP  
Form 10-Q  
November 09, 2012

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2012

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

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

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

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

Accelerated filer   
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 8, 2012 was 9,248,449.

FIRST NORTHERN COMMUNITY BANCORP

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## 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>2012 | December<br>31,<br>2011 |
|--|--------------------------|-------------------------|
| <b>Assets</b>  |                          |                         |
| Cash and cash equivalents  | \$ 129,212               | \$ 140,172              |
| Investment securities – available-for-sale   | 182,943                  | 160,241                 |
| Loans, net of allowance for loan losses of \$9,817 at September 30, 2012<br>and \$10,408 at December 31, 2011  | 444,803                  | 432,789                 |
| Loans held-for-sale  | 5,929                    | 2,832                   |
| Stock in Federal Home Loan Bank and other equity securities, at cost   | 3,607                    | 3,075                   |
| Premises and equipment, net  | 7,929                    | 8,054                   |
| Other real estate owned  | 899                      | 1,325                   |
| Interest receivable and other assets   | 30,243                   | 32,662                  |
| <b>Total Assets</b>  | <b>\$ 805,565</b>        | <b>\$ 781,150</b>       |
| <b>Liabilities and Stockholders' Equity</b>  |                          |                         |
| <b>Liabilities:</b>  |                          |                         |
| Demand deposits  | \$ 219,515               | \$ 201,865              |
| Interest-bearing transaction deposits  | 174,980                  | 160,956                 |
| Savings and MMDA's   | 218,815                  | 209,853                 |
| Time, under \$100,000  | 36,271                   | 38,395                  |
| Time, \$100,000 and over   | 56,276                   | 67,889                  |
| Total deposits   | 705,857                  | 678,958                 |
| Federal Home Loan Bank advances and other borrowings   | —                        | 7,000                   |
| Interest payable and other liabilities   | 7,985                    | 7,490                   |
| <b>Total Liabilities</b>   | <b>713,842</b>           | <b>693,448</b>          |
| <b>Stockholders' Equity:</b>   |                          |                         |
| Preferred stock, no par value; \$1,000 per share liquidation preference,<br>22,847 shares authorized; 22,847 issued and outstanding at<br>September 30, 2012 and December 31, 2011 | 22,847                   | 22,847                  |
| Common stock, no par value; 16,000,000 shares authorized;  |                          |                         |

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|   |           |           |
|---|-----------|-----------|
| 9,248,449 shares issued and outstanding at September 30, 2012 and<br>9,144,998 shares issued and outstanding at December 31, 2011 | 63,289    | 62,751    |
| Additional paid-in capital  | 977       | 977       |
| Retained earnings   | 3,056     | 864       |
| Accumulated other comprehensive income, net   | 1,554     | 263       |
| Total Stockholders' Equity  | 91,723    | 87,702    |
| Total Liabilities and Stockholders' Equity  | \$805,565 | \$781,150 |

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,<br>2012 | Three<br>months<br>ended<br>September<br>30,<br>2011 | Nine<br>months<br>ended<br>September<br>30, 2012 | Nine<br>months<br>ended<br>September<br>30,<br>2011 |
|--|--|--|--|---|
| <b>Interest and dividend income:</b>                     |  |  |  |   |
| Loans  | \$6,211  | \$6,480  | \$18,245   | \$19,083  |
| Due from banks interest bearing accounts                 | 77   | 72   | 251  | 248   |
| <b>Investment securities</b>                             |  |  |  |   |
| Taxable  | 756  | 663  | 2,334  | 1,921   |
| Non-taxable  | 103  | 106  | 310  | 325   |
| Other earning assets                                     | 5  | 2  | 17   | 6   |
| <b>Total interest and dividend income</b>                | <b>7,152</b>   | <b>7,323</b>   | <b>21,157</b>                                    | <b>21,583</b>                                       |
| <b>Interest expense:</b>                                 |  |  |  |   |
| Deposits   | 375  | 524  | 1,305  | 1,649   |
| Other borrowings   | —  | 72   | 141  | 253   |
| <b>Total interest expense</b>                            | <b>375</b>   | <b>596</b>   | <b>1,446</b>                                     | <b>1,902</b>  |
| Net interest income                                      | 6,777  | 6,727  | 19,711   | 19,681  |
| Provision for loan losses                                | 825  | 1,190  | 2,051  | 3,670   |
| Net interest income after provision<br>for loan losses   | 5,952  | 5,537  | 17,660   | 16,011  |
| <b>Other operating income:</b>                           |  |  |  |   |
| Service charges on deposit accounts                      | 697  | 723  | 2,023  | 2,136   |
| Gains on sales of other real estate owned                | —  | 13   | 17   | 228   |
| Gains on sales of loans held-for-sale                    | 510  | 176  | 1,410  | 444   |
| Investment and brokerage services income                 | 258  | 365  | 761  | 905   |
| Mortgage brokerage income                                | 28   | 12   | 74   | 39  |
| Loan servicing income                                    | 67   | 5  | 351  | 393   |
| Fiduciary activities income                              | 133  | 99   | 361  | 285   |
| ATM fees   | 107  | 125  | 365  | 349   |
| Signature based transaction fees                         | 283  | 248  | 797  | 692   |
| Gains on calls/sales of available-for-sale<br>securities | —  | 177  | 1  | 633   |
| Other income   | 223  | 511  | 612  | 903   |
| <b>Total other operating income</b>                      | <b>2,306</b>   | <b>2,454</b>   | <b>6,772</b>                                     | <b>7,007</b>  |
| <b>Other operating expenses:</b>                         |  |  |  |   |
| Salaries and employee benefits                           | 3,901  | 3,885  | 11,625   | 11,219  |
| Occupancy and equipment                                  | 665  | 738  | 2,149  | 2,370   |
| Data processing  | 400  | 443  | 1,220  | 1,227   |
| Stationery and supplies                                  | 92   | 67   | 263  | 230   |
| Advertising  | 69   | 137  | 273  | 422   |
| Directors' fees  | 56   | 52   | 166  | 176   |

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|  |         |         |         |           |
|--|---------|---------|---------|-----------|
| Other real estate owned expense and impairment | 3       | 148     | 63      | 662       |
| Other expense                                  | 1,284   | 1,318   | 3,729   | 3,702     |
| Total other operating expenses                 | 6,470   | 6,788   | 19,488  | 20,008    |
| Income before income tax expense               | 1,788   | 1,203   | 4,944   | 3,010     |
| Income tax expense                             | 584     | 255     | 1,441   | 501       |
| Net income                                     | \$1,204 | \$948   | \$3,503 | \$2,509   |
| Preferred stock dividends and accretion        | \$(286) | \$(607) | \$(857) | \$(1,107) |
| Net income available to common stockholders    | \$918   | \$341   | \$2,646 | \$1,402   |
| Basic income per share                         | \$0.10  | \$0.04  | \$0.29  | \$0.15    |
| Diluted income per share                       | \$0.10  | \$0.04  | \$0.29  | \$0.15    |

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>2012 | Three<br>months<br>ended<br>September<br>30,<br>2011 | Nine<br>months<br>ended<br>September<br>30,<br>2012 | Nine<br>months<br>ended<br>September<br>30,<br>2011 |
|---|--|--|---|---|
| Net income  | \$1,204  | \$948  | \$3,503   | \$2,509   |
| Other comprehensive income, net of tax:   |  |  |   |   |
| Unrealized holding gains on securities:   |  |  |   |   |
| Unrealized holding gains arising during the period, net of tax effect of \$295 and \$488 for the three-month periods ended September 30, 2012 and September 30, 2011, respectively, and \$861 and \$1,198 for the nine-month periods ended September 30, 2012 and September 30, 2011, respectively                      | 445  | 730  | 1,292   | 1,798   |
| Less: reclassification adjustment due to gains realized on sales of securities, net of tax effect of \$0 and \$71 for the three-month periods ended September 30, 2012 and September 30, 2011, respectively, and \$0 and \$253 for the nine-month periods ended September 30, 2012 and September 30, 2011, respectively | —  | (106 )   | (1 )  | (380 )  |
| Other comprehensive income  | \$445  | \$624  | \$1,291   | \$1,418   |
| Comprehensive income  | \$1,649  | \$1,572  | \$4,794   | \$3,927   |

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         | Retained | Accumulated<br>Other<br>Comprehensive | Total     |
|---|-----------------|-----------|--------------|-----------|--------------------|----------|---------------------------------------|-----------|
|   | Shares          | Amounts   | Shares       | Amounts   | Paid-in<br>Capital | Earnings | Income                                |           |
| Balance at<br>December 31,<br>2011                                    | 22,847          | \$ 22,847 | 9,144,998    | \$ 62,751 | \$ 977             | \$ 864   | \$ 263                                | \$ 87,702 |
| Net income  |                 |           |              |           |                    | 3,503    |                                       | 3,503     |
| Other<br>comprehensive<br>income                                      |                 |           |              |           |                    |          | 1,291                                 | 1,291     |
| 1% stock<br>dividend  |                 |           | 91,052       | 451       |                    | (451 )   |                                       | —         |
| Dividend on<br>preferred stock  |                 |           |              |           |                    | (857 )   |                                       | (857 )    |
| Cash in lieu of<br>fractional shares                                  |                 |           |              |           |                    | (3 )     |                                       | (3 )      |
| Stock-based<br>compensation<br>and related tax<br>benefits            |                 |           |              | 87        |                    |          |                                       | 87        |
| Common shares<br>issued related to<br>restricted stock<br>grants, net |                 |           | 12,399       |           |                    |          |                                       | —         |
| Balance at<br>September 30,<br>2012                                   | 22,847          | \$ 22,847 | 9,248,449    | \$ 63,289 | \$ 977             | \$ 3,056 | \$ 1,554                              | \$ 91,723 |

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 September<br>30, 2012 | Nine months<br>ended September<br>30, 2011 |
| <b>Cash Flows From Operating Activities</b>  |   |  |
| Net Income   | \$3,503                                       | 2,509                                      |
| Adjustments to reconcile net income to net cash provided by operating activities:    |   |  |
| Depreciation   | 518   | 554  |
| Valuation adjustment on mortgage servicing rights                                    | 141   | (105 )                                     |
| Provision for loan losses  | 2,051   | 3,670                                      |
| Stock plan accruals  | 87  | 128  |
| Gains on calls/sales of available-for-sale securities                                | (1 )  | (633 )                                     |
| Gains on sales of other real estate owned  | (17 )   | (228 )                                     |
| Impairment on other real estate owned  | 16  | 431  |
| Gains on sales of loans held-for-sale  | (1,410 )                                      | (444 )                                     |
| Proceeds from sales of loans held-for-sale   | 59,496  | 23,412                                     |
| Originations of loans held-for-sale  | (61,183 )                                     | (24,042 )                                  |
| Changes in assets and liabilities:   |   |  |
| Decrease (increase) in interest receivable and other assets                          | 1,417   | (1,882 )                                   |
| Increase in interest payable and other liabilities                                   | 495   | 99   |
| Net cash provided by operating activities  | 5,113   | 3,469                                      |
| <b>Cash Flows From Investing Activities</b>  |   |  |
| Net increase in investment securities  | (20,549 )                                     | (28,407 )                                  |
| Net (increase) decrease in loans   | (16,040 )                                     | 7,133                                      |
| Net increase in stock in Federal Home Loan Bank and other equity securities, at cost | (532 )  | (252 )                                     |
| Proceeds from the sale of other real estate owned                                    | 2,402   | 3,089                                      |
| Purchases of premises and equipment, net   | (393 )  | (557 )                                     |
| Net cash used in investing activities  | (35,112 )                                     | (18,994 )                                  |
| <b>Cash Flows From Financing Activities</b>  |   |  |
| Net increase in deposits   | 26,899  | 22,514                                     |
| Net decrease in FHLB advances and other borrowings                                   | (7,000 )                                      | (2,029 )                                   |
| Proceeds from issuance of preferred stock  | —   | 22,847                                     |
| Redemption of preferred stock  | —   | (17,390 )                                  |
| Cash dividends paid in lieu of fractional shares                                     | (3 )  | —  |
| Cash dividends paid on preferred stock   | (857 )  | (660 )                                     |
| Net cash provided by financing activities  | 19,039  | 25,282                                     |
| Net (decrease) increase in Cash and Cash Equivalents                                 | (10,960 )                                     | 9,757                                      |

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|  |            |          |
|--|------------|----------|
| Cash and Cash Equivalents, beginning of period                           | 140,172    | 139,707  |
| Cash and Cash Equivalents, end of period                                 | \$ 129,212 | 149,464  |
| Supplemental Disclosures of Cash Flow Information:                       |            |          |
| Cash paid during the period for:   |            |          |
| Interest   | \$ 1,477   | \$ 1,937 |
| Income Taxes   | \$ 1,294   | \$ 1,067 |
| Supplemental disclosures of non-cash investing and financing activities: |            |          |
| Preferred stock accretion  | \$ —       | \$ 446   |
| Stock dividend distributed   | \$ 451     | \$ —     |
| Transfer of loans held-for-investment to other real estate owned         | \$ 1,975   | \$ 3,197 |
| Unrealized holding gains on available for sale securities, net of taxes  | \$ 1,291   | \$ 1,418 |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012 and 2011 and December 31, 2011

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, 2011 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 May 2011, the Financial Accounting Standards Board (“FASB”) issued ASU 2011-04. This update represents the converged guidance of the FASB and the International Accounting Standards Board (the Boards) on fair value measurement. The collective efforts of the Boards and their staffs have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term “fair value.” The amendments in this ASU are to be applied prospectively and are effective during interim and annual periods beginning after December 15, 2011. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements.

In June 2011, FASB issued ASU 2011-05. This update allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendments in this ASU are to be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements. In December 2011, FASB issued ASU 2011-12. This update defers the effective date for amendments to the presentation of reclassifications of items out of accumulated other comprehensive income in ASU 2011-05.

In December 2011, FASB issued ASU 2011-11. The amendments in this ASU require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments in this ASU are required for annual reporting

periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures required by those amendments should be provided retrospectively for all comparative periods presented. 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>2012 | December<br>31,<br>2011 |
|---|--------------------------|-------------------------|
| Commercial                              | \$93,888                 | \$91,914                |
| Commercial Real Estate                  | 192,750                  | 175,793                 |
| Agriculture                             | 49,103                   | 52,064                  |
| Residential Mortgage                    | 49,652                   | 51,586                  |
| Residential Construction                | 7,582                    | 7,492                   |
| Consumer                                | 60,872                   | 64,150                  |
|   | 453,847                  | 442,999                 |
| Allowance for loan losses               | (9,817 )                 | (10,408 )               |
| Net deferred origination fees and costs | 773                      | 198                     |
| Loans, net                              | \$444,803                | \$432,789               |

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.

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.

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. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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 documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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 service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily 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. 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. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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 other 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 documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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 collateral value. In general, non-payment is usually due to loss of employment and will follow general economic trends in the economy, particularly the upward movements in the unemployment rate, loss of collateral value, and demand shifts.

As of September 30, 2012, approximately 42% in principal amount of the Company's loans were secured by commercial real estate, which consists of construction and land development loans and real estate



loans. Approximately 11% of the Company's loans were residential mortgage loans. Approximately 2% of the Company's loans were residential construction loans. Approximately 11% of the Company's loans were for agriculture and 21% of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 13% 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 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.

All loans at September 30, 2012 and December 31, 2011 were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank and Federal Reserve.

#### Non-accrual and Past Due Loans

The Company's non-accrual loans by loan class, as of September 30, 2012 and December 31, 2011 were as follows:

| (\$ in thousands)        | September<br>30,<br>2012 | December<br>31,<br>2011 |
|--------------------------|--------------------------|-------------------------|
| Commercial               | \$2,916                  | \$2,905                 |
| Commercial Real Estate   | 3,628                    | 3,071                   |
| Agriculture              | -                        | 992                     |
| Residential Mortgage     | 2,136                    | 1,334                   |
| Residential Construction | 42                       | 48                      |
| Consumer                 | 230                      | 360                     |
|                          | \$8,952                  | \$8,710                 |

Non-accrual loans amounted to \$8,952,000 at September 30, 2012 and were comprised of seven residential mortgage loans totaling \$2,136,000, one residential construction loan totaling \$42,000, six commercial real estate loans totaling \$3,628,000, eleven commercial loans totaling \$2,916,000 and five consumer loans totaling \$230,000. Non-accrual loans amounted to \$8,710,000 at December 31, 2011 and were comprised of four residential mortgage loans totaling \$1,334,000, one residential construction loan totaling \$48,000, six commercial real estate loans totaling \$3,071,000, one agricultural loan totaling \$992,000, twelve commercial loans totaling \$2,905,000 and five consumer loans totaling \$360,000. 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, 2012 and December 31, 2011 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 |
|--------------------------|------------------------|------------------------|--------------------------------|-------------------|-----------|-------------|
| September 30, 2012       |                        |                        |                                |                   |           |             |
| Commercial               | \$859                  | \$859                  | \$148                          | \$1,866           | \$92,022  | \$93,888    |
| Commercial Real Estate   | 1,067                  | —                      | 3,481                          | 4,548             | 188,202   | 192,750     |
| Agriculture              | —                      | —                      | —                              | —                 | 49,103    | 49,103      |
| Residential Mortgage     | 602                    | 136                    | 1,276                          | 2,014             | 47,638    | 49,652      |
| Residential Construction | 109                    | —                      | 42                             | 151               | 7,431     | 7,582       |
| Consumer                 | 1                      | 171                    | 127                            | 299               | 60,573    | 60,872      |
| Total                    | \$2,638                | \$1,166                | \$5,074                        | \$8,878           | \$444,969 | \$453,847   |
| December 31, 2011        |                        |                        |                                |                   |           |             |
| Commercial               | \$1,051                | \$166                  | \$113                          | \$1,330           | \$90,584  | \$91,914    |
| Commercial Real Estate   | —                      | 2,746                  | 446                            | 3,192             | 172,601   | 175,793     |
| Agriculture              | —                      | —                      | 991                            | 991               | 51,073    | 52,064      |
| Residential Mortgage     | 792                    | 420                    | 426                            | 1,638             | 49,948    | 51,586      |
| Residential Construction | 273                    | —                      | 48                             | 321               | 7,171     | 7,492       |
| Consumer                 | 20                     | 212                    | 225                            | 457               | 63,693    | 64,150      |
| Total                    | \$2,136                | \$3,544                | \$2,249                        | \$7,929           | \$435,070 | \$442,999   |

The Company had no loans 90 days or more past due and still accruing at September 30, 2012 and December 31, 2011.

## Impaired Loans

Impaired loans, segregated by loan class, as of September 30, 2012 and December 31, 2011 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, 2012       |   |  |   |                                 |                      |
| Commercial               | \$ 3,944                                      | \$ 2,793                                       | \$ 811                                      | \$ 3,604                        | \$ 152               |
| Commercial Real Estate   | 5,439   | 3,628  | 1,172                                       | 4,800                           | 19                   |
| Agriculture              | —   | —  | —   | —                               | —                    |
| Residential Mortgage     | 5,912   | 2,136  | 2,769                                       | 4,905                           | 497                  |
| Residential Construction | 1,360   | 42   | 1,105                                       | 1,147                           | 563                  |
| Consumer                 | 998   | 230  | 634   | 864                             | 86                   |
| Total                    | \$ 17,653                                     | \$ 8,829                                       | \$ 6,491                                    | \$ 15,320                       | \$ 1,317             |
| December 31, 2011        |   |  |   |                                 |                      |
| Commercial               | \$ 4,694                                      | \$ 2,919                                       | \$ 569                                      | \$ 3,488                        | \$ 101               |
| Commercial Real Estate   | 4,856   | 3,071  | 1,198                                       | 4,269                           | 22                   |
| Agriculture              | 3,847   | 3,598  | —   | 3,598                           | —                    |
| Residential Mortgage     | 5,336   | 1,875  | 3,194                                       | 5,069                           | 731                  |
| Residential Construction | 1,147   | 48   | 1,099                                       | 1,147                           | 668                  |
| Consumer                 | 985   | 309  | 346   | 655                             | 126                  |
| Total                    | \$ 20,865                                     | \$ 11,820                                      | \$ 6,406                                    | \$ 18,226                       | \$ 1,648             |

Interest income on impaired loans recognized using a cash-basis method of accounting during the three-month periods ended September 30, 2012 and 2011 was as follows:

| (\$ in thousands)        | Three Months Ended<br>September 30, 2012 |                                  | Three Months Ended<br>September 30, 2011 |                                  |
|--------------------------|--|----------------------------------|--|----------------------------------|
|                          | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized |
| Commercial               | \$ 3,713                                 | \$ 8                             | \$ 3,619                                 | \$ 62                            |
| Commercial Real Estate   | 5,019                                    | 23                               | 9,880                                    | 78                               |
| Agriculture              | 449                                      | —                                | 1,062                                    | 2                                |
| Residential Mortgage     | 4,446                                    | 39                               | 5,455                                    | 64                               |
| Residential Construction | 1,137                                    | 12                               | 1,416                                    | 14                               |
| Consumer                 | 949                                      | 4                                | 446                                      | 1                                |
| Total                    | \$ 15,713                                | \$ 86                            | \$ 21,875                                | \$ 221                           |



Interest income on impaired loans recognized using a cash-basis method of accounting during the nine-month periods ended September 30, 2012 and 2011 was as follows:

| (\$ in thousands)        | Nine months Ended<br>September 30, 2012 |                                  | Nine months Ended<br>September 30, 2011 |                                  |
|--------------------------|---|----------------------------------|---|----------------------------------|
|                          | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| Commercial               | \$3,689                                 | \$ 28                            | \$3,242                                 | \$ 102                           |
| Commercial Real Estate   | 4,745                                   | 68                               | 8,455                                   | 378                              |
| Agriculture              | 1,517                                   | —                                | 1,597                                   | 6                                |
| Residential Mortgage     | 4,374                                   | 98                               | 5,834                                   | 152                              |
| Residential Construction | 1,178                                   | 38                               | 1,611                                   | 54                               |
| Consumer                 | 874                                     | 21                               | 402                                     | 5                                |
| Total                    | \$16,377                                | \$ 253                           | \$21,141                                | \$ 697                           |

#### 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. These concessions typically result from the Company's loss mitigation activities and could 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 nine 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 \$7,068,000 and \$9,410,000 in TDR loans as of September 30, 2012 and December 31, 2011, respectively. Specific reserves for TDR loans totaled \$1,158,000 and \$1,596,000 as of September 30, 2012 and December 31, 2011, respectively. TDR loans performing in compliance with modified terms totaled \$6,294,000 and \$7,471,000 as of September 30, 2012 and December 31, 2011, respectively.

Loans modified as troubled debt restructurings during the three-month periods ended September 30, 2012 and September 30, 2011 were as follows:

| (\$ in thousands) | Three Months Ended September 30, 2012 |  |   |
|-------------------|---------------------------------------|--|---|
|                   | Number of Contracts                   | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Consumer          | 2                                     | \$ 142   | \$ 142  |
| Total             | 2                                     | \$ 142   | \$ 142  |

| (\$ in thousands)        | Three Months Ended September 30, 2011 |  |   |
|--------------------------|---------------------------------------|--|---|
|                          | Number of Contracts                   | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial               | 2                                     | \$ 397   | \$ 397  |
| Residential Construction | 1                                     | 295  | 295   |
| Total                    | 3                                     | \$ 692   | \$ 692  |

Loans modified as troubled debt restructurings during the nine-month periods ended September 30, 2012 and September 30, 2011 were as follows:

| (\$ in thousands) | Nine months Ended September 30, 2012 |  |   |
|-------------------|--------------------------------------|--|---|
|                   | Number of Contracts                  | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial        | 4                                    | \$ 361   | \$ 361  |
| Consumer          | 6                                    | 572  | 572   |
| Total             | 10                                   | \$ 933   | \$ 933  |

| (\$ in thousands)        | Nine months Ended September 30, 2011 |  |   |
|--------------------------|--------------------------------------|--|---|
|                          | Number of Contracts                  | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial               | 3                                    | \$ 445   | \$ 445  |
| Residential Mortgage     | 1                                    | 404  | 404   |
| Residential Construction | 2                                    | 221  | 162   |
| Consumer                 | 1                                    | 295  | 295   |
| Total                    | 7                                    | \$ 1,365   | \$ 1,306  |

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. 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 periods ended September 30, 2012 and September 30, 2011. There was one commercial loan with a recorded investment of \$136,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the nine-month period ended September 30, 2012. There was one consumer loan with a recorded investment of \$25,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the nine-month period ended September 30, 2011.



## Credit Quality Indicators

All new 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. General definitions for each risk rating are as follows:

**Risk Rating “1” – Pass (High Quality):** This category is reserved for loans fully secured by Company CD’s or savings and properly margined (as defined in the Company’s Credit Policy) and actively traded securities (including stocks, as well as corporate, municipal and U.S. Government bonds).

**Risk Rating “2” – Pass (Above Average Quality):** This category is reserved for borrowers with strong balance sheets that are well structured with manageable levels of debt and good liquidity. Cash flow is sufficient to service all debt as agreed. Historical earnings, cash flow, and payment performance have all been strong and trends are positive and consistent. Collateral protection is better than the Company’s Credit Policy guidelines.

**Risk Rating “3” – Pass (Average Quality):** Credits within this category are considered to be of average, but acceptable, quality. Loan characteristics, including term and collateral advance rates, meet the Company’s Credit Policy guidelines; unsecured lines to borrowers with above average liquidity and cash flow may be considered for this category; the borrower’s financial strength is well documented, with adequate, but consistent, cash flow to meet all obligations. Liquidity should be sufficient and leverage should be moderate. Monitoring of collateral may be required, including a borrowing base or construction budget. Alternative financing is typically available.

**Risk Rating “4” – Pass (Below Average Quality):** Credits within this category are considered sound, but merit additional attention due to industry concentrations within the borrower’s customer base, problems within their industry, deteriorating financial or earnings trends, declining collateral values, increased frequency of past due payments and/or overdrafts, discovery of documentation deficiencies which may impair our borrower’s ability to repay, or the Company’s ability to liquidate collateral. Financial performance is average but inconsistent. There also may be changes of ownership, management or professional advisors, which could be detrimental to the borrower’s future performance.

**Risk Rating “5” – Special Mention (Criticized):** Loans in this category are currently protected by their collateral value and have no loss potential identified, but have potential weaknesses which may, if not monitored or corrected, weaken our ability to collect payments from the borrower or satisfactorily liquidate our collateral position. Loans where terms have been modified due to their failure to perform as agreed may be included in this category. Adverse trends in the borrower’s operation, such as reporting losses or inadequate cash flow, increasing and unsatisfactory leverage, or an adverse change in economic or market conditions may have weakened the borrower’s business and impaired their ability to repay based on original terms. The condition or value of the collateral has deteriorated to the point where adequate protection for our loan may be jeopardized in the future. Loans in this category are in transition and, generally, do not remain in this category beyond 12 months. During this time, efforts are focused on strategies aimed at upgrading the credit or locating alternative financing.

**Risk Rating “6” – Substandard (Classified):** Loans in this category are inadequately protected by the borrower’s net worth, capacity to repay or collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. There exists a strong possibility of loss if the deficiencies are not corrected. Loans that are dependent on the liquidation of collateral to repay are included in this category, as well as borrowers in bankruptcy or where legal action is required to effect collection of our debt.

Risk Rating “7” – Doubtful (Classified): Loans in this category indicate all of the weaknesses of a Substandard classification, however, collection of loan principal, in full, is highly questionable and improbable; possibility of loss is very high, but there is still a possibility that certain collection strategies may, yet, be successful, rendering a definitive loss difficult to estimate, at the time. Loans in this category are in transition and, generally, do not remain in this category more than 6 months.

## Risk Rating “8” – Loss (Classified):

Active Charge-Off. Loans in this category are considered uncollectible and of such little value that their removal from the Company’s books is required. The charge-off is pending or already processed. Collateral positions have been or are in the process of being liquidated and the borrower/guarantor may or may not be cooperative in repayment of the debt. Recovery prospects are unknown at the time, but we are still actively engaged in the collection of the loan.

Inactive Charge-Off. Loans in this category are considered uncollectible and of such little value that their removal from the Company’s books is required. The charge-off is pending or already processed. Collateral positions have been liquidated and the borrower/guarantor has nothing of any value remaining to apply to the repayment of our loan. Any further collection activities would be of little value.

The following table presents the risk ratings by loan class as of September 30, 2012 and December 31, 2011.

| (\$ in thousands)        | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|--------------------------|-----------|--------------------|-------------|----------|------|-----------|
| September 30, 2012       |           |                    |             |          |      |           |
| Commercial               | \$77,283  | \$6,119            | \$10,486    | \$—      | \$—  | \$93,888  |
| Commercial Real Estate   | 172,687   | 8,579              | 11,484      | —        | —    | 192,750   |
| Agriculture              | 47,987    | 1,116              | —           | —        | —    | 49,103    |
| Residential Mortgage     | 43,357    | 1,455              | 4,840       | —        | —    | 49,652    |
| Residential Construction | 4,882     | 1,624              | 1,076       | —        | —    | 7,582     |
| Consumer                 | 53,736    | 3,253              | 3,809       | 74       | —    | 60,872    |
| Total                    | \$399,932 | \$22,146           | \$31,695    | \$74     | \$—  | \$453,847 |
| December 31, 2011        |           |                    |             |          |      |           |
| Commercial               | \$71,229  | \$8,444            | \$11,804    | \$437    | \$—  | \$91,914  |
| Commercial Real Estate   | 148,317   | 16,492             | 10,984      | —        | —    | 175,793   |
| Agriculture              | 48,330    | —                  | 3,734       | —        | —    | 52,064    |
| Residential Mortgage     | 42,845    | 1,830              | 6,911       | —        | —    | 51,586    |
| Residential Construction | 5,140     | 927                | 1,425       | —        | —    | 7,492     |
| Consumer                 | 58,239    | 2,824              | 3,087       | —        | —    | 64,150    |
| Total                    | \$374,100 | \$30,517           | \$37,945    | \$437    | \$—  | \$442,999 |

## 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, 2012.

## Three-month period ended September 30, 2012

| (\$ in thousands)                | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total   |
|----------------------------------|------------|-------------|-------------|-------------|--------------------------|----------|-------------|---------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |         |
| Balance as of June 30, 2012      | \$ 2,782   | \$ 2,062    | \$ 1,126    | \$ 1,616    | \$ 934                   | \$ 1,101 | \$ 163      | \$9,784 |
| Provision for loan losses        | 341        | 203         | (244 )      | 223         | (102 )                   | 100      | 304         | 825     |
| Charge-offs                      | (25 )      | (4 )        | —           | (833 )      | —                        | (34 )    | —           | (896 )  |
| Recoveries                       | 41         | —           | —           | —           | 36                       | 27       | —           | 104     |
| Net charge-offs                  | 16         | (4 )        | —           | (833 )      | 36                       | (7 )     | —           | (792 )  |
| Balance as of September 30, 2012 | 3,139      | 2,261       | 882         | 1,006       | 868                      | 1,194    | 467         | 9,817   |

## Nine-month period ended September 30, 2012

| (\$ in thousands)                | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total    |
|----------------------------------|------------|-------------|-------------|-------------|--------------------------|----------|-------------|----------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |          |
| Balance as of December 31, 2011  | \$ 3,598   | \$ 1,747    | \$ 1,934    | \$ 1,135    | \$ 1,198                 | \$ 796   | \$ —        | \$10,408 |
| Provision for loan losses        | 367        | 860         | (940 )      | 735         | (429 )                   | 991      | 467         | 2,051    |
| Charge-offs                      | (1,104 )   | (346 )      | (115 )      | (864 )      | (161 )                   | (668 )   | —           | (3,258 ) |
| Recoveries                       | 278        | —           | 3           | —           | 260                      | 75       | —           | 616      |
| Net charge-offs                  | (826 )     | (346 )      | (112 )      | (864 )      | 99                       | (593 )   | —           | (2,642 ) |
| Balance as of September 30, 2012 | 3,139      | 2,261       | 882         | 1,006       | 868                      | 1,194    | 467         | 9,817    |

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, 2012.

| (\$ in thousands)               | Commercial |             |             | Residential |                          | Consumer | Unallocated | Total |
|---------------------------------|------------|-------------|-------------|-------------|--------------------------|----------|-------------|-------|
|                                 | Commercial | Real Estate | Agriculture | Mortgage    | Residential Construction |          |             |       |
| Period-end amount allocated to: | 152        | 19          | —           | 497         | 563                      | 86       | —           | 1,317 |

Loans individually  
evaluated for  
impairment

Loans collectively  
evaluated for  
impairment

|                |          |          |        |          |        |          |         |         |
|----------------|----------|----------|--------|----------|--------|----------|---------|---------|
| Ending Balance | \$ 3,139 | \$ 2,261 | \$ 882 | \$ 1,006 | \$ 868 | \$ 1,194 | \$ 1467 | \$9,817 |
|----------------|----------|----------|--------|----------|--------|----------|---------|---------|

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, 2011.

## Three-month period ended September 30, 2011

| (\$ in thousands)                | Commercial |             |             |                      |                          |          |        | Unallocated | Total |
|----------------------------------|------------|-------------|-------------|----------------------|--------------------------|----------|--------|-------------|-------|
|                                  | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |        |             |       |
| Balance as of June 30, 2011      | \$ 3,629   | \$ 1,626    | \$ 2,555    | \$ 950               | \$ 1,238                 | \$ 508   | \$ 278 | \$ 10,784   |       |
| Provision for loan losses        | (83 )      | 348         | 405         | 345                  | (12 )                    | 362      | (175 ) | 1,190       |       |
| Charge-offs                      | (275 )     | (1 )        | (290 )      | (37 )                | —                        | (233 )   | —      | (836 )      |       |
| Recoveries                       | 119        | 128         | 24          | —                    | 2                        | 26       | —      | 299         |       |
| Net charge-offs                  | (156 )     | 127         | (266 )      | (37 )                | 2                        | (207 )   | —      | (537 )      |       |
| Balance as of September 30, 2011 | 3,390      | 2,101       | 2,694       | 1,258                | 1,228                    | 663      | 103    | 11,437      |       |

## Nine-month period ended September 30, 2011

| (\$ in thousands)                | Commercial |             |             |                      |                          |          |       | Unallocated | Total |
|----------------------------------|------------|-------------|-------------|----------------------|--------------------------|----------|-------|-------------|-------|
|                                  | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |       |             |       |
| Balance as of December 31, 2010  | \$ 3,761   | \$ 1,957    | \$ 2,141    | \$ 830               | \$ 1,719                 | \$ 556   | \$ 75 | \$ 11,039   |       |
| Provision for loan losses        | 399        | 1,283       | 1,023       | 645                  | (346 )                   | 638      | 28    | 3,670       |       |
| Charge-offs                      | (941 )     | (1,414 )    | (610 )      | (228 )               | (198 )                   | (681 )   | —     | (4,042 )    |       |
| Recoveries                       | 141        | 275         | 140         | 11                   | 53                       | 150      | —     | 770         |       |
| Net charge-offs                  | (770 )     | (1,139 )    | (470 )      | (217 )               | (145 )                   | (531 )   | —     | (3,272 )    |       |
| Balance as of September 30, 2011 | 3,390      | 2,101       | 2,694       | 1,258                | 1,228                    | 663      | 103   | 11,437      |       |

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, 2011.

| (\$ in thousands)                           | Commercial |             |             |                      |                          |          |     | Unallocated | Total |
|---|------------|-------------|-------------|----------------------|--------------------------|----------|-----|-------------|-------|
|   | Commercial | Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer |     |             |       |
| Period-end amount allocated to:             |            |             |             |                      |                          |          |     |             |       |
| Loans individually evaluated for impairment | 73         | 633         | —           | 898                  | 643                      | 121      | —   | 2,368       |       |
| Loans collectively evaluated for impairment | 3,317      | 1,468       | 2,694       | 360                  | 585                      | 542      | 103 | 9,069       |       |

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|                |          |          |          |          |          |        |        |          |
|----------------|----------|----------|----------|----------|----------|--------|--------|----------|
| Ending Balance | \$ 3,390 | \$ 2,101 | \$ 2,694 | \$ 1,258 | \$ 1,228 | \$ 663 | \$ 103 | \$11,437 |
|----------------|----------|----------|----------|----------|----------|--------|--------|----------|

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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, 2011.

| (\$ in thousands)                           | Commercial |             | Agriculture | Residential |                          | Consumer | Unallocated | Total    |
|---|------------|-------------|-------------|-------------|--------------------------|----------|-------------|----------|
|   | Commercial | Real Estate |             | Mortgage    | Residential Construction |          |             |          |
| Balance as of December 31, 2010             | \$ 3,761   | \$ 1,957    | \$ 2,141    | \$ 830      | \$ 1,719                 | \$ 556   | \$ 75       | \$11,039 |
| Provision for loan losses                   | 2,033      | 1,502       | 511         | 566         | (395 )                   | 996      | (75 )       | 5,138    |
| Charge-offs                                 | (2,381 )   | (2,000 )    | (860 )      | (272 )      | (197 )                   | (932 )   | —           | (6,642 ) |
| Recoveries                                  | 185        | 288         | 142         | 11          | 71                       | 176      | —           | 873      |
| Net charge-offs                             | (2,196 )   | (1,712 )    | (718 )      | (261 )      | (126 )                   | (756 )   | —           | (5,769 ) |
| Balance as of December 31, 2011             | 3,598      | 1,747       | 1,934       | 1,135       | 1,198                    | 796      | —           | 10,408   |
| Period-end amount allocated to:             |            |             |             |             |                          |          |             |          |
| Loans individually evaluated for impairment | 101        | 22          | —           | 731         | 668                      | 126      | —           | 1,648    |
| Loans collectively evaluated for impairment | 3,497      | 1,725       | 1,934       | 404         | 530                      | 670      | —           | 8,760    |
| Ending Balance                              | \$ 3,598   | \$ 1,747    | \$ 1,934    | \$ 1,135    | \$ 1,198                 | \$ 796   | \$ —        | \$10,408 |

The Company's investment in loans as of September 30, 2012, September 30, 2011, and December 31, 2011 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, 2012                          |            |             |             |             |                          |           |            |
| Loans individually evaluated for impairment | \$ 3,604   | \$ 4,800    | \$—         | \$ 4,905    | \$ 1,147                 | \$ 864    | \$15,320   |
| Loans collectively evaluated for impairment | 90,284     | 187,950     | 49,103      | 44,747      | 6,435                    | 60,008    | 438,527    |
| Ending Balance                              | \$ 93,888  | \$ 192,750  | \$ 49,103   | \$ 49,652   | \$ 7,582                 | \$ 60,872 | \$ 453,847 |
| September 30, 2011                          |            |             |             |             |                          |           |            |
| Loans individually evaluated for            | \$ 3,478   | \$ 7,557    | \$ 280      | \$ 5,159    | \$ 1,437                 | \$ 591    | \$ 18,502  |



impairment

Loans

collectively

evaluated for

impairment

|  |        |         |        |        |       |        |         |
|--|--------|---------|--------|--------|-------|--------|---------|
|  | 77,977 | 170,596 | 55,482 | 45,080 | 6,689 | 64,967 | 420,791 |
|--|--------|---------|--------|--------|-------|--------|---------|

Ending Balance

|           |            |           |           |          |           |            |
|-----------|------------|-----------|-----------|----------|-----------|------------|
| \$ 81,455 | \$ 178,153 | \$ 55,762 | \$ 50,239 | \$ 8,126 | \$ 65,558 | \$ 439,293 |
|-----------|------------|-----------|-----------|----------|-----------|------------|

December 31, 2011

Loans

individually

evaluated for

impairment

|          |          |          |          |          |        |           |
|----------|----------|----------|----------|----------|--------|-----------|
| \$ 3,488 | \$ 4,269 | \$ 3,598 | \$ 5,069 | \$ 1,147 | \$ 655 | \$ 18,226 |
|----------|----------|----------|----------|----------|--------|-----------|

Loans

collectively

evaluated for

impairment

|        |         |        |        |       |        |         |
|--------|---------|--------|--------|-------|--------|---------|
| 88,426 | 171,524 | 48,466 | 46,517 | 6,345 | 63,495 | 424,773 |
|--------|---------|--------|--------|-------|--------|---------|

Ending Balance

|           |            |           |           |          |           |            |
|-----------|------------|-----------|-----------|----------|-----------|------------|
| \$ 91,914 | \$ 175,793 | \$ 52,064 | \$ 51,586 | \$ 7,492 | \$ 64,150 | \$ 442,999 |
|-----------|------------|-----------|-----------|----------|-----------|------------|

### 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, 2012 for cash proceeds equal to the fair value of the loans.

The recorded value of mortgage servicing rights is included in other assets, 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.

At September 30, 2012, the Company had \$5,929,000 of mortgage loans held-for-sale. At September 30, 2012 and December 31, 2011, the Company serviced real estate mortgage loans for others of \$223,402,000 and \$211,535,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2012 and December 31, 2011.

|   | (in thousands)       |           |            |                       |
|---|----------------------|-----------|------------|-----------------------|
|   | December<br>31, 2011 | Additions | Reductions | September<br>30, 2012 |
| Mortgage servicing rights                             | \$1,636              | \$459     | \$382      | \$1,713               |
| Valuation allowance                                   | (347 )               | (141 )    | —          | (488 )                |
| Mortgage servicing rights, net of valuation allowance | \$1,289              | \$318     | \$382      | \$1,225               |

## 4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 26, 2012, the Board of Directors of the Company declared a 1% stock dividend payable as of March 30, 2012. 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 period. Diluted EPS includes 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 an entity.

The following table presents a reconciliation of basic and diluted EPS for the three-month and nine-month periods ended September 30, 2012 and 2011.

|   | Three months ended<br>September 30, |           | Nine months ended<br>September 30, |            |
|---|-------------------------------------|-----------|------------------------------------|------------|
|   | 2012                                | 2011      | 2012                               | 2011       |
| Basic earnings per share:                           |                                     |           |                                    |            |
| Net income  | \$1,204                             | \$948     | \$3,503                            | \$2,509    |
| Preferred stock dividend and accretion              | \$(286 )                            | \$(607 )  | \$(857 )                           | \$(1,107 ) |
| Net income available to common stockholders         | \$918                               | \$341     | \$2,646                            | \$1,402    |
| Weighted average common shares outstanding          | 9,201,668                           | 9,161,197 | 9,198,882                          | 9,156,811  |
| Basic EPS   | \$0.10                              | \$0.04    | \$0.29                             | \$0.15     |
| Diluted earnings per share:                         |                                     |           |                                    |            |
| Net income  | \$1,204                             | \$948     | \$3,503                            | \$2,509    |
| Preferred stock dividend and accretion              | \$(286 )                            | \$(607 )  | \$(857 )                           | \$(1,107 ) |
| Net income available to common stockholders         | \$918                               | \$341     | \$2,646                            | \$1,402    |
| Weighted average common shares outstanding          | 9,201,668                           | 9,161,197 | 9,198,882                          | 9,156,811  |
| Effect of dilutive shares                           | 25,321                              | 9         | 25,249                             | 1,160      |
| Adjusted weighted average common shares outstanding | 9,226,989                           | 9,161,206 | 9,224,131                          | 9,157,971  |
| Diluted EPS   | \$0.10                              | \$0.04    | \$0.29                             | \$0.15     |

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 349,809 shares and 421,665 shares for the three months ended September 30, 2012 and 2011, 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 347,527 shares and 428,989 shares for the nine months ended September 30, 2012 and 2011, respectively. There were no non-vested shares of restricted stock not included in the computation of diluted earnings per share because they would have an anti-dilutive effect for the three-month and nine-month periods ended September 30, 2012. Non-vested shares of restricted stock not included in the computation of diluted earnings per share because they would have an anti-dilutive effect amounted to 46,781 shares for the three-month and nine-month periods ended September 30, 2011. In addition, warrants for 352,977

shares issued to the U.S. Treasury were not used in the computation of diluted earnings per share for the three-month and nine-month periods ended September 30, 2011 because they would have had an anti-dilutive effect.

## 5. STOCK PLANS

On January 26, 2012, the Board of Directors of the Company declared a 1% stock dividend payable as of March 30, 2012. All options outstanding 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, 2012.

|  | 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 | 375,563             | \$ 11.94                                 |                                 |   |
| Granted                                    | —                   | —  |                                 |   |
| Expired                                    | —                   | —  |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  |                                 |   |
| Options outstanding at End of Period       | 375,563             | \$ 11.94                                 | \$ 44,338                       | 3.12  |
| Exercisable (vested) at End of Period      | 339,313             | \$ 12.71                                 | \$ 18,640                       | 2.55  |

The following table presents the activity related to stock options for the nine months ended September 30, 2012.

|  | 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 | 421,697             | \$ 11.65                                 |                                 |   |
| Granted                                    | 14,975              | \$ 5.00                                  |                                 |   |
| Expired                                    | (61,109 )           | \$ 8.24                                  |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  |                                 |   |
| Options outstanding at End of Period       | 375,563             | \$ 11.94                                 | \$ 44,338                       | 3.12  |

|                                       |         |         |          |      |
|---------------------------------------|---------|---------|----------|------|
| Exercisable (vested) at End of Period | 339,313 | \$12.71 | \$18,640 | 2.55 |
|---------------------------------------|---------|---------|----------|------|

The weighted average fair value of options granted during the nine-month period ended September 30, 2012 was \$2.40 per share.

As of September 30, 2012, there was \$62,000 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 2.66 years.

There was \$21,000 of recognized compensation cost related to stock options granted for the nine months ended September 30, 2012.

A summary of the weighted average assumptions used in valuing stock options during the three months and nine months ended September 30, 2012 is presented below.

|                           | Three<br>Months<br>Ended<br>September<br>30, 2012* | Nine<br>months<br>Ended<br>September<br>30, 2012 |   |
|---------------------------|--|--|---|
| Risk Free Interest Rate   | —  | 2.37   | % |
| Expected Dividend Yield   | —  | 0.00   | % |
| Expected Life in Years    | —  | 5  |   |
| Expected Price Volatility | —  | 53.06  | % |

\* There were no stock options or restricted stock granted during the three-month period ended September 30, 2012.

The following table presents the activity related to restricted stock for the three months ended September 30, 2012.

|   | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|---|---------------------|---|------------------------------|--|
| Restricted stock outstanding at Beginning of Period | 46,781              | \$4.62  |                              |  |
| Granted   | —                   | —   |                              |  |
| Cancelled / Forfeited                               | —                   | —   |                              |  |
| Exercised/Released/Vested                           | —                   | —   |                              |  |
| Restricted stock outstanding at End of Period       | 46,781              | \$4.62  | \$252,617                    | 8.10   |

The following table presents the activity related to restricted stock for the nine months ended September 30, 2012.

|  | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|--|---------------------|---|------------------------------|--|
|  | 46,013              | \$7.16  |                              |  |

|   |           |         |           |      |
|---|-----------|---------|-----------|------|
| Restricted stock outstanding at Beginning of Period |           |         |           |      |
| Granted   | 13,193    | \$5.00  |           |      |
| Cancelled / Forfeited                               | (529 )    | \$9.79  |           |      |
| Exercised/Released/Vested                           | (11,896 ) | \$14.64 |           |      |
| Restricted stock outstanding at End of Period       | 46,781    | \$4.62  | \$252,617 | 8.10 |



The weighted average fair value of restricted stock granted during the nine-month period ended September 30, 2012 was \$5.00 per share.

As of September 30, 2012, there was \$116,000 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 2.67 years.

There was \$44,000 of recognized compensation cost related to restricted stock awards for the nine months ended September 30, 2012.

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 295,057 (adjusted for the 2012 stock dividend) shares authorized under the ESPP. The ESPP will terminate February 27, 2017. 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, 2011 to November 23, 2012. 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 market value on the last trading day before the date of participation or the fair market value on the last trading day during the participation period.

As of September 30, 2012, there was \$7,000 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 \$21,000 of recognized compensation cost related to ESPP issuances for the nine-month period ended September 30, 2012.

There were no ESPP issuances during the three-month period ended September 30, 2012. The weighted average fair value at issuance date during the nine-month period ended September 30, 2012 was \$0.99.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three months and nine months ended September 30, 2012 is presented below.

|                           | Three Months Ended<br>September 30, 2012 | Nine months Ended<br>September 30, 2012 |
|---------------------------|--|---|
| Risk Free Interest Rate   | 0.10%                                    | 0.10%                                   |
| 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.

### 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, 2012 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. 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, 2012, 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, subsequent to foreclosure. 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. This model 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, 2012.

| September 30, 2012                                      | (in thousands) |         |         |         |
|---|----------------|---------|---------|---------|
|   | Total          | Level 1 | Level 2 | Level 3 |
| U.S. Treasury securities                                | \$2,007        | \$2,007 | \$—     | \$—     |
| Securities of U.S. government agencies and corporations | 27,383         | —       | 27,383  | —       |
| Obligations of states and                               |                |         |         |         |

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|                                     |            |          |            |     |
|-------------------------------------|------------|----------|------------|-----|
| political subdivisions              | 27,172     | —        | 27,172     | —   |
| Collateralized mortgage obligations | 8,336      | —        | 8,336      |     |
| Mortgage-backed securities          | 118,045    | —        | 118,045    | —   |
| Total investments at fair value     | \$ 182,943 | \$ 2,007 | \$ 180,936 | \$— |

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The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2011.

| December 31, 2011                                       | (in thousands) |         |           |         |
|---|----------------|---------|-----------|---------|
|   | Total          | Level 1 | Level 2   | Level 3 |
| U.S. Treasury securities                                | \$2,314        | \$2,314 | \$—       | \$—     |
| Securities of U.S. government agencies and corporations | 37,014         | —       | 37,014    | —       |
| Obligations of states and political subdivisions        | 20,617         | —       | 20,617    | —       |
| Mortgage-backed securities                              | 100,296        | —       | 100,296   | —       |
| Total investments at fair value                         | \$160,241      | \$2,314 | \$157,927 | \$—     |

Assets Recorded at Fair Value on a Non-Recurring Basis

The Company may be required, from time to time, to measure certain assets at fair value on a non-recurring basis in accordance with U.S. GAAP. These include assets that are measured at the lower of cost or market where fair value is below cost at the end of the period.

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, 2012.

| September 30, 2012         | (in thousands) |         |         |         |
|----------------------------|----------------|---------|---------|---------|
|                            | Total          | Level 1 | Level 2 | Level 3 |
| Impaired loans             | \$3,410        | \$—     | \$—     | \$3,410 |
| Other real estate owned    | 899            | —       | —       | 899     |
| Loan servicing rights      | 1,225          | —       | —       | 1,225   |
| Total assets at fair value | \$5,208        | \$—     | \$—     | \$5,208 |

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, 2011.

| December 31, 2011          | (in thousands) |         |         |         |
|----------------------------|----------------|---------|---------|---------|
|                            | Total          | Level 1 | Level 2 | Level 3 |
| Impaired loans             | \$4,008        | \$—     | \$—     | \$4,008 |
| Other real estate owned    | 1,001          | —       | —       | 1,001   |
| Loan servicing rights      | 1,289          | —       | —       | 1,289   |
| Total assets at fair value | \$6,298        | \$—     | \$—     | \$6,298 |

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2012 and December 31, 2011.





## 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. Also, on November 16, 2011 the Company repurchased from the U.S. Treasury a warrant to purchase 352,977 shares of the Company's common stock at an exercise price of \$7.39 per share (the "Warrant"), issued to the U.S. Treasury on March 13, 2009, in connection with the Company's participation in the Troubled Asset Relief Program (TARP) Capital Purchase Program. The Company paid an aggregate purchase price of \$375,000 for the repurchase of the Warrant, which has been canceled. The repurchase price was based on the fair market value of the Warrant as agreed upon by the Company and U.S. Treasury. With the repurchase of the Warrant, the Company concluded its participation in the TARP Capital Purchase 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 balance sheet 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 balance sheet approximate fair value. 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, carrying value approximates fair value. 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 3 inputs.

### 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.

### FHLB Advances and Other Borrowings

The fair values of borrowed funds were estimated by discounting future cash flows related to these financial instruments using current market rates for financial instruments with similar characteristics. The Company believes the measurement of the fair value of FHLB advances and other borrowings is derived from Level 2 inputs.

### 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, 2012 and December 31, 2011 are approximately as follows:

| (in thousands)            | Level | September 30, 2012<br>Carrying<br>amount | Fair<br>value |
|---------------------------|-------|--|---------------|
| Financial assets:         |       |  |               |
| Cash and cash equivalents | 1     | \$ 129,212                               | \$ 129,212    |
| Other equity securities   | 2     | 3,607                                    | 3,607         |
| Loans:                    |       |  |               |
| Net loans                 | 3     | 444,803                                  | 442,519       |
| Loans held-for-sale       | 2     | 5,929                                    | 6,228         |
| Interest receivable       | 3     | 2,823                                    | 2,823         |
| Financial liabilities:    |       |  |               |
| Deposits                  | 3     | 705,857                                  | 695,249       |
| Interest payable          | 3     | 103                                      | 103           |

| (in thousands)                     | December 31, 2011<br>Carrying<br>amount | Fair<br>value |
|------------------------------------|---|---------------|
| Financial assets:                  |   |               |
| Cash and cash equivalents          | \$ 140,172                              | \$ 140,172    |
| Other equity securities            | 3,075                                   | 3,075         |
| Loans:                             |   |               |
| Net loans                          | 432,789                                 | 430,071       |
| Loans held-for-sale                | 2,832                                   | 2,917         |
| Interest receivable                | 2,710                                   | 2,710         |
| Financial liabilities:             |   |               |
| Deposits                           | 678,958                                 | 671,399       |
| FHLB advances and other borrowings | 7,000                                   | 7,070         |
| Interest payable                   | 134                                     | 134           |

## 9. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2012 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|---------------------|----------------------|-------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                         |
| U.S. Treasury securities                                | \$1,996           | \$11                | \$—                  | \$2,007                 |
| Securities of U.S. government agencies and corporations | 27,245            | 138                 | —                    | 27,383                  |
| Obligations of states and political subdivisions        | 25,595            | 1,598               | (21 )                | 27,172                  |
| Collateralized mortgage obligations                     | 8,203             | 133                 | —                    | 8,336                   |
| Mortgage-backed securities                              | 116,490           | 1,653               | (98 )                | 118,045                 |
| <b>Total debt securities</b>                            | <b>\$179,529</b>  | <b>\$3,533</b>      | <b>\$(119 )</b>      | <b>\$182,943</b>        |

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2011 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|---------------------|----------------------|-------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                         |
| U.S. Treasury securities                                | \$2,294           | \$20                | \$—                  | \$2,314                 |
| Securities of U.S. government agencies and corporations | 36,820            | 203                 | (9 )                 | 37,014                  |
| Obligations of states and political subdivisions        | 19,735            | 894                 | (12 )                | 20,617                  |
| Mortgage-backed securities                              | 100,130           | 586                 | (420 )               | 100,296                 |
| <b>Total debt securities</b>                            | <b>\$158,979</b>  | <b>\$1,703</b>      | <b>\$(441 )</b>      | <b>\$160,241</b>        |

There were no proceeds from sales of available-for-sale securities for the nine-month and three-month periods ended September 30, 2012. Proceeds from sales of available-for-sale securities were \$24,640,000 and \$6,558,000 for the nine-month and three-month periods ended September 30, 2011. Gross realized gains from calls of available-for-sale securities were \$1 and \$0 for the nine-month and three-month periods ended September 30, 2012, respectively. Gross realized gains from available-for-sale securities were \$633,000 and \$177,000 for the nine-month and three-month periods ended September 30, 2011. There were no gross realized losses from sales of available-for-sale securities for the nine-month and three-month periods ended September 30, 2012 and September 30, 2011.

The amortized cost and estimated market value of debt and other securities at September 30, 2012, 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                | \$14,862          | \$14,920                |
| Due after one year through five years  | 123,826           | 125,606                 |
| Due after five years through ten years | 28,596            | 29,470                  |
| Due after ten years                    | 12,245            | 12,947                  |

\$179,529      \$182,943

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 with expected maturities totaling \$101,793,000. 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, 2012, follows:

| (in thousands)                                   | Less than 12 months |                   | 12 months or more |                   | Total            |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------------|-------------------|
|  | Fair Value          | Unrealized losses | Fair Value        | Unrealized losses | Fair Value       | Unrealized losses |
| Obligations of states and political subdivisions | \$ 1,134            | \$ (21 )          | \$ —              | \$ —              | \$ 1,134         | \$ (21 )          |
| Mortgaged-backed securities                      | 14,493              | (98 )             | —                 | —                 | 14,493           | (98 )             |
| <b>Total</b>                                     | <b>\$ 15,627</b>    | <b>\$ (119 )</b>  | <b>—</b>          | <b>—</b>          | <b>\$ 15,627</b> | <b>\$ (119 )</b>  |

No decline in value was considered “other-than-temporary” during 2012. Eleven securities that had a fair value of \$15,627,000 and a total unrealized loss of \$119,000 have been in an unrealized loss position for less than twelve months as of September 30, 2012. The declines in fair value were primarily attributable to changes in interest rates. 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, 2011, follows:

| (in thousands)  | Less than 12 months |                   | 12 months or more |                   | Total           |                   |
|---|---------------------|-------------------|-------------------|-------------------|-----------------|-------------------|
|   | Fair Value          | Unrealized losses | Fair Value        | Unrealized losses | Fair Value      | Unrealized losses |
| Securities of U.S. government agencies and corporations | \$4,034             | \$ (9 )           | \$—               | \$—               | \$4,034         | \$ (9 )           |
| Obligations of states and political subdivisions        | 506                 | (10 )             | 167               | (2 )              | 673             | (12 )             |
| Mortgage-backed securities                              | 47,861              | (420 )            | —                 | —                 | 47,861          | (420 )            |
| <b>Total</b>  | <b>\$52,401</b>     | <b>\$ (439 )</b>  | <b>\$167</b>      | <b>\$ (2 )</b>    | <b>\$52,568</b> | <b>\$ (441 )</b>  |

Investment securities carried at \$32,406,000 and \$34,206,000 at September 30, 2012 and December 31, 2011, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.



## 10. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table details activity in accumulated other comprehensive income for the three-month period ended September 30, 2012.

| (\$ in thousands)                         | Unrealized<br>Gains on<br>Securities | Directors'<br>and<br>officers'<br>retirement<br>plans | Accumulated<br>Other<br>Comprehensive<br>Income |
|---|--------------------------------------|---|---|
| Balance as of June 30, 2012               | \$1,604                              | \$(495 )  | \$ 1,109  |
| Current period other comprehensive income | 445                                  | —   | 445   |
| Balance as of September 30, 2012          | \$2,049                              | \$(495 )  | \$ 1,554  |

The following table details activity in accumulated other comprehensive income for the nine-month period ended September 30, 2012.

| (\$ in thousands)                         | Unrealized<br>Gains on<br>Securities | Directors' and<br>officers'<br>retirement<br>plans | Accumulated<br>Other<br>Comprehensive<br>Income |
|---|--------------------------------------|--|---|
| Balance as of December 31, 2011           | \$758                                | \$ (495 )  | \$ 263  |
| Current period other comprehensive income | 1,291                                | —  | 1,291   |
| Balance as of September 30, 2012          | \$2,049                              | \$ (495 )  | \$ 1,554  |

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 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 2011 Annual Report on Form 10-K for factors to be considered when reading any forward-looking statements in this filing.

This report 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,” “estimate,” “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 the forward-looking statements are made.

In this document, for example we make forward-looking statements relating to the following topics:

- Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position
  - 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 grade
  - 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 legislation and governmental measures enacted or introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy
  - Regulatory controls and processes and their impact on our business
    - The costs and effects of legal actions
    - Our regulatory capital requirements
  - We do not anticipate paying a cash dividend in the foreseeable future
- Our assessment of economic conditions and trends and credit cycles and their impact on our business
  - The impact of changes in interest rates and our strategy to manage our interest rate risk profile

- Loan portfolio composition and risk grade trends, expected charge offs, delinquency rates and our underwriting standards

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- The Company believes that the Bank’s deposit base does not involve any undue concentration levels from one person or industry
  - Our intent to sell, and the likelihood that we would be required to sell, various investment securities
    - Our liquidity position
- Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or change in accounting principles
  - Expected rates of return, yields and projected results

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 2011 Annual Report on Form 10-K.

## 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, 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, 2011.

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 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 2012 include:

- Net income of \$3.5 million for the nine months ended September 30, 2012, up 40.0% from the \$2.5 million for the same fiscal period last year.
- Net income available to common stockholders of \$2.6 million for the nine months ended September 30, 2012, up 85.7% from the \$1.4 million for the same fiscal period last year. Net income available to common stockholders for the nine months ended September 30, 2011 was impacted by a one time charge totaling \$0.4 million due to the early recognition of the remaining discount on preferred stock sold to the U.S. Treasury as part of the Troubled Asset Relief Program.
- Diluted income per share for the nine-month period ended September 30, 2012 was \$0.29, up 93.3% from the diluted income per share of \$0.15 reported in the same period last year.
- Net interest income increased in the nine months ended September 30, 2012 by \$30,000, or 0.15%, to \$19.71 million from \$19.68 million in the same period last year. The increase in net interest income was primarily attributable to a decrease in interest costs, partially offset by a decrease in interest yields. Net interest margin decreased from 3.79% for the nine-month period ending September 30, 2011 to 3.57% for the same period ending September 30, 2012.
- Provision for loan losses of \$2.05 million for the nine-month period ended September 30, 2012 compared to a provision for loan losses of \$3.67 million for the same period in 2011.
- Total assets at September 30, 2012 were \$805.6 million, an increase of \$24.4 million, or 3.2%, from levels at December 31, 2011.
- Total net loans at September 30, 2012 (including loans held-for-sale) increased \$15.1 million, or 3.5%, to \$450.7 million compared to December 31, 2011.
- Total investment securities at September 30, 2012 increased \$22.7 million, or 14.2%, to \$182.9 million compared to December 31, 2011.
- Total deposits of \$705.9 million at September 30, 2012, represented an increase of \$26.9 million, or 4.0%, compared to December 31, 2011.

- Net income of \$1.2 million for the three months ended September 30, 2012, up 33.3% from the \$0.9 million for the same fiscal period last year.
- Net income available to common stockholders of \$0.9 million for the three months ended September 30, 2012, up 200.0% from the \$0.3 million for the same fiscal period last year. Net income available to common stockholders for the three months ended September 30, 2011 was impacted by a one time charge totaling \$0.4 million due to the early recognition of the remaining discount on preferred stock sold to the US Treasury as part of the Troubled Asset Relief Program.
- Diluted income per share for the three-month period ended September 30, 2012 was \$0.10, up 150.0% from the diluted income per share of \$0.04 reported in the same period last year.

## SUMMARY

The Company recorded net income of \$3,503,000 for the nine-month period ended September 30, 2012, representing an increase of \$994,000 from net income of \$2,509,000 for the same period in 2011.

The following tables present a summary of the results for the three-month and nine-month periods ended September 30, 2012 and 2011, and a summary of financial condition at September 30, 2012 and December 31, 2011.

|  | Three<br>months<br>ended<br>September<br>30, 2012 | Three<br>months<br>ended<br>September<br>30, 2011 | Nine<br>months<br>ended<br>September<br>30, 2012 | Nine<br>months<br>ended<br>September<br>30, 2011 |
|--|---|---|--|--|
|--|---|---|--|--|

(in thousands except for per share amounts)

For the Period:

|                                   |         |        |         |         |
|-----------------------------------|---------|--------|---------|---------|
| Net Income                        | \$1,204 | \$948  | \$3,503 | \$2,509 |
| Basic Earnings Per Common Share   | \$0.10  | \$0.04 | \$0.29  | \$0.15  |
| Diluted Earnings Per Common Share | \$0.10  | \$0.04 | \$0.29  | \$0.15  |

|  | September<br>30, 2012 | December<br>31, 2011 |
|--|-----------------------|----------------------|
|--|-----------------------|----------------------|

(in thousands except for ratios)

At Period End:

|  |           |           |   |
|--|-----------|-----------|---|
| Total Assets                                     | \$805,565 | \$781,150 |   |
| Total Loans, Net (including loans held-for-sale) | \$450,732 | \$435,621 |   |
| Total Investment Securities                      | \$182,943 | \$160,241 |   |
| Total Deposits                                   | \$705,857 | \$678,958 |   |
| Loan-To-Deposit Ratio                            | 63.9      | % 64.2    | % |

## 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, 2012 |          |                |   | Three months ended<br>September 30, 2011 |          |                |   |
|---|--|----------|----------------|---|--|----------|----------------|---|
|   | Average<br>Balance                       | Interest | Yield/<br>Rate |   | Average<br>Balance                       | Interest | Yield/<br>Rate |   |
| Assets  |  |          |                |   |  |          |                |   |
| Interest-earning assets:                              |  |          |                |   |  |          |                |   |
| Loans (1)   | \$446,874                                | \$6,211  | 5.51           | % | \$432,348                                | \$6,480  | 5.95           | % |
| Interest bearing due from banks                       | 107,311                                  | 77       | 0.28           | % | 122,739                                  | 72       | 0.23           | % |
| Investment securities, taxable                        | 172,516                                  | 756      | 1.74           | % | 126,252                                  | 663      | 2.08           | % |
| Investment securities,<br>non-taxable (2)             | 10,470                                   | 103      | 3.90           | % | 10,451                                   | 106      | 4.02           | % |
| Other interest earning assets                         | 3,607                                    | 5        | 0.55           | % | 3,075                                    | 2        | 0.26           | % |
| Total average interest-earning<br>assets              | 740,778                                  | 7,152    | 3.83           | % | 694,865                                  | 7,323    | 4.18           | % |
| Non-interest-earning assets:                          |  |          |                |   |  |          |                |   |
| Cash and due from banks                               | 16,527                                   |          |                |   | 15,342                                   |          |                |   |
| Premises and equipment, net                           | 8,005                                    |          |                |   | 8,105                                    |          |                |   |
| Other real estate owned                               | 565                                      |          |                |   | 1,386                                    |          |                |   |
| Interest receivable and other<br>assets               | 30,279                                   |          |                |   | 34,152                                   |          |                |   |
| Total average assets                                  | 796,154                                  |          |                |   | 753,850                                  |          |                |   |
| Liabilities and Stockholders' Equity:                 |  |          |                |   |  |          |                |   |
| Interest-bearing liabilities:                         |  |          |                |   |  |          |                |   |
| Interest-bearing transaction                          |  |          |                |   |  |          |                |   |
| deposits  | 171,184                                  | 61       | 0.14           | % | 154,233                                  | 89       | 0.23           | % |
| Savings and MMDA's                                    | 214,161                                  | 160      | 0.30           | % | 202,856                                  | 207      | 0.40           | % |
| Time, under \$100,000                                 | 36,916                                   | 48       | 0.52           | % | 38,391                                   | 58       | 0.60           | % |
| Time, \$100,000 and over                              | 59,364                                   | 106      | 0.71           | % | 66,163                                   | 170      | 1.02           | % |
| FHLB advances and other<br>borrowings                 | —  | —        | —              | % | 8,108                                    | 72       | 3.52           | % |
| Total average interest-bearing<br>liabilities         | 481,625                                  | 375      | 0.31           | % | 469,751                                  | 596      | 0.50           | % |
| Non-interest-bearing liabilities:                     |  |          |                |   |  |          |                |   |
| Non-interest-bearing demand                           |  |          |                |   |  |          |                |   |
| deposits  | 216,059                                  |          |                |   | 193,862                                  |          |                |   |
| Interest payable and other<br>liabilities             | 7,433                                    |          |                |   | 6,988                                    |          |                |   |
| Total liabilities                                     | 705,117                                  |          |                |   | 670,601                                  |          |                |   |
| Total average stockholders'<br>equity                 | 91,037                                   |          |                |   | 83,249                                   |          |                |   |
| Total average liabilities and<br>stockholders' equity | \$796,154                                |          |                |   | \$753,850                                |          |                |   |



|   |         |      |   |         |      |   |
|---|---------|------|---|---------|------|---|
| Net interest income and net interest margin (3) | \$6,777 | 3.63 | % | \$6,727 | 3.84 | % |
|---|---------|------|---|---------|------|---|

1. Average balances for loan 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 \$257 and \$253 for the three months ended September 30, 2012 and 2011, 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.

## 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, 2012 |          |                |   | Nine months ended<br>September 30, 2011 |          |                |   |
|---|---|----------|----------------|---|---|----------|----------------|---|
|   | Average<br>Balance                      | Interest | Yield/<br>Rate |   | Average<br>Balance                      | Interest | Yield/<br>Rate |   |
| Assets  |   |          |                |   |   |          |                |   |
| Interest-earning assets:                              |   |          |                |   |   |          |                |   |
| Loans (1)   | \$433,928                               | \$18,245 | 5.60           | % | \$429,980                               | \$19,083 | 5.93           | % |
| Interest bearing due from banks                       | 116,261                                 | 251      | 0.29           | % | 132,973                                 | 248      | 0.25           | % |
| Investment securities, taxable                        | 171,639                                 | 2,334    | 1.81           | % | 117,382                                 | 1,921    | 2.19           | % |
| Investment securities,<br>non-taxable (2)             | 10,490                                  | 310      | 3.94           | % | 10,374                                  | 325      | 4.19           | % |
| Other interest earning assets                         | 3,374                                   | 17       | 0.67           | % | 2,964                                   | 6        | 0.27           | % |
| Total average interest-earning<br>assets              | 735,692                                 | 21,157   | 3.83           | % | 693,673                                 | 21,583   | 4.16           | % |
| Non-interest-earning assets:                          |   |          |                |   |   |          |                |   |
| Cash and due from banks                               | 15,809                                  |          |                |   | 15,562                                  |          |                |   |
| Premises and equipment, net                           | 8,068                                   |          |                |   | 8,085                                   |          |                |   |
| Other real estate owned                               | 960                                     |          |                |   | 2,316                                   |          |                |   |
| Interest receivable and other<br>assets               | 31,244                                  |          |                |   | 33,367                                  |          |                |   |
| Total average assets                                  | 791,773                                 |          |                |   | 753,003                                 |          |                |   |
| Liabilities and Stockholders' Equity:                 |   |          |                |   |   |          |                |   |
| Interest-bearing liabilities:                         |   |          |                |   |   |          |                |   |
| Interest-bearing transaction                          |   |          |                |   |   |          |                |   |
| deposits  | 165,745                                 | 243      | 0.20           | % | 151,186                                 | 261      | 0.23           | % |
| Savings and MMDA's                                    | 214,933                                 | 531      | 0.33           | % | 207,409                                 | 681      | 0.44           | % |
| Time, under \$100,000                                 | 40,035                                  | 155      | 0.52           | % | 39,232                                  | 182      | 0.62           | % |
| Time, \$100,000 and over                              | 60,511                                  | 376      | 0.83           | % | 66,250                                  | 525      | 1.06           | % |
| FHLB advances and other<br>borrowings                 | 4,599                                   | 141      | 4.08           | % | 9,458                                   | 253      | 3.58           | % |
| Total average interest-bearing<br>liabilities         | 485,823                                 | 1,446    | 0.40           | % | 473,535                                 | 1,902    | 0.54           | % |
| Non-interest-bearing liabilities:                     |   |          |                |   |   |          |                |   |
| Non-interest-bearing demand                           |   |          |                |   |   |          |                |   |
| deposits  | 209,087                                 |          |                |   | 191,345                                 |          |                |   |
| Interest payable and other<br>liabilities             | 7,120                                   |          |                |   | 6,808                                   |          |                |   |
| Total liabilities                                     | 702,030                                 |          |                |   | 671,688                                 |          |                |   |
| Total average stockholders'<br>equity                 | 89,743                                  |          |                |   | 81,315                                  |          |                |   |
| Total average liabilities and<br>stockholders' equity | \$791,773                               |          |                |   | \$753,003                               |          |                |   |

|   |          |      |   |          |      |   |
|---|----------|------|---|----------|------|---|
| Net interest income and net interest margin (3) | \$19,711 | 3.57 | % | \$19,681 | 3.79 | % |
|---|----------|------|---|----------|------|---|

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 \$711 and \$612 for the nine months ended September 30, 2012 and 2011, 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.

## CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a \$10,960,000 decrease in cash and cash equivalents, a \$22,702,000 increase in investment securities available-for-sale, a \$12,014,000 increase in net loans held-for-investment, a \$532,000 increase in other interest earning assets, a \$426,000 decrease in other real estate owned and a \$2,419,000 decrease in interest receivable and other assets from December 31, 2011 to September 30, 2012. The decrease in cash and cash equivalents was due to a decrease in interest bearing due from bank accounts, combined with a slight increase in non-interest bearing due from bank accounts. The increase in investment securities available-for-sale was primarily the result of purchases of municipal bonds, collateralized mortgage obligations, and mortgage backed securities, partially offset by calls of agency and municipal bonds. The increase in loans held-for-investment was due to increases in the following loan categories as a result of increased loan demand: equipment; financed equipment leases; real estate commercial and construction. The increase in loans held-for-investment was partially offset by decreases in the following loan categories: commercial and industrial; agricultural; true equipment leases; consumer; real estate; real estate SBA (Small Business Administration); home equity lines. The increase in other interest earning assets was due to purchases of Federal Home Loan Bank stock. The decrease in other real estate owned is due to the sale of four other real estate owned properties, combined with the addition of three other real estate owned properties, for a net of one other real estate owned property remaining. The decrease in interest receivable and other assets was mainly due to decreases in income taxes receivable, housing tax credits, prepaid expenses and suspense & holdovers, which was partially offset by increases in accrued income on securities, accrued income on loans and unamortized loan costs.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of \$26,899,000 from December 31, 2011 to September 30, 2012. The increase in deposits was due to increases in demand deposits, interest-bearing transaction deposits, and savings and money market accounts, which were partially offset by decreases in time deposits.

Federal Home Loan Bank advances (“FHLB advances”) and other borrowings decreased \$7,000,000 from December 31, 2011 to September 30, 2012, due to maturing FHLB advances.

## CHANGES IN RESULTS OF OPERATIONS

### Interest Income

The Federal Open Market Committee made no changes to the Federal Funds rate during the twelve-month period ended September 30, 2012.

Interest income on loans for the nine-month period ended September 30, 2012 was down 4.4% from the same period in 2011, decreasing from \$19,083,000 to \$18,245,000 and was down 4.2% for the three-month period ended September 30, 2012 over the same period in 2011, from \$6,480,000 to \$6,211,000. The decrease in interest income on loans for the nine-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to a 33 basis point decrease in loan yields, partially offset by an increase in average loans. The decrease in interest income on loans for the three-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to a 44 basis point decrease in loan yields, partially offset by an increase in average loans. The decrease in loan yields was primarily due to repricing of loans at lower rates.

Interest income on investment securities available-for-sale for the nine-month period ended September 30, 2012 was up 17.7% from the same period in 2011, increasing from \$2,246,000 to \$2,644,000 and was up 11.7% for the three-month period ended September 30, 2012 over the same period in 2011, from \$769,000 to \$859,000. The increase in interest income on investment securities for the nine-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to an increase in average investment securities, partially offset by a 41 basis point decrease in investment securities yields. The increase in interest income on investment securities for the three-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to an increase in average investment securities, partially offset by a 37 basis point decrease in investment securities yields. The decrease in investment securities yields for the three-month and nine-month periods ended September 30, 2012 was primarily due to reinvestment of maturing securities at lower rates and purchases of securities at lower rates.

Interest income on interest-bearing due from banks for the nine-month period ended September 30, 2012 was up 1.2% from the same period in 2011, increasing from \$248,000 to \$251,000 and was up 6.9% for the three-month period ended September 30, 2012 over the same period in 2011, from \$72,000 to \$77,000. The increase in interest income on interest-bearing due from banks for the nine-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to a 4 basis point increase in interest bearing due from banks yield, partially offset by a decrease in average interest-bearing due from banks. The increase in interest income on interest-bearing due from banks for the three-month period ended September 30, 2012 as compared to the same period a year ago was primarily due to a 5 basis point increase in interest bearing due from banks yield, partially offset by a decrease in average interest-bearing due from banks.

The Company had no Federal Funds sold balances during the three-month and nine-month periods ended September 30, 2012 and September 30, 2011.

### Interest Expense

The sustained low interest rate environment decreased the Company's cost of funds in the first nine months of 2012 compared to the same period a year ago.

Interest expense on deposits and other borrowings for the nine-month period ended September 30, 2012 was down 24.0% from the same period in 2011, decreasing from \$1,902,000 to \$1,446,000 and was down 37.1% for the three-month period ended September 30, 2012 over the same period in 2011, from \$596,000 to \$375,000. The decrease in interest expense during the nine-month period ended September 30, 2012 was due to a 14 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The decrease in interest expense during the three-month period ended September 30, 2012 was due to a 19 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The decrease in average cost of funds for the three-month and nine-month periods ended September 30, 2012 is primarily due to the maturing and repricing of time deposits and a change in the mix of interest-bearing liabilities, which resulted in an increase in lower cost deposits.

### Provision for Loan Losses

There was a provision for loan losses of \$2,051,000 for the nine-month period ended September 30, 2012 compared to a provision for loan losses of \$3,670,000 for the same period in 2011. There was a provision for loan losses of \$825,000 for the three-month period ended September 30, 2012 compared to a provision for loan losses of \$1,190,000 for the same period in 2011. The allowance for loan losses was approximately \$9,817,000, or 2.16% of total loans, at September 30, 2012 compared to \$10,408,000, or 2.35% of total loans, at December 31, 2011. 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 decrease in the provision for loan losses during the nine-month period in 2012 was primarily due to decreased net charge-offs, partially offset by increased loan volumes compared to the nine-month period in 2011. The decrease in the provision for loan losses during the three-month period in 2012 was primarily due to improved overall loan quality.

### Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the nine-month period ended September 30, 2012 compared to a recovery of provision for unfunded lending commitment losses of \$24,000 for the nine-month period ended September 30, 2011. There was no provision for unfunded lending commitment losses for the three-month periods ended September 30, 2012 and September 30, 2011.

The provision for unfunded lending commitment losses is included in non-interest expense.

## Other Operating Income

Other operating income was down 3.4% for the nine-month period ended September 30, 2012 from the same period in 2011, decreasing from \$7,007,000 to \$6,772,000.

This decrease was primarily due to decreases in service charges on deposit accounts, gains on sales of other real estate owned, investment and brokerage services income, loan servicing income, and gains on sales of available for sale securities, which was partially offset by increases in gains on loans held-for-sale, mortgage brokerage income, fiduciary activities income, ATM fees, signature based transaction fees and other income. The decrease in service charges on deposit accounts is primarily due to decreases in service charges on checking accounts. The decrease in gains on other real estate owned was primarily due to five properties sold during the nine-month period ended September 30, 2012, compared to ten properties sold during the nine-month period ended September 30, 2011. The decrease in investment and brokerage services income was due to a decrease in the demand for those services. The decrease in loan servicing income was primarily due to an increase in impairment expense and amortization expense, partially offset by an increase in mortgage servicing assets recorded. The decrease in gains on sales of available for sale securities is primarily due to a decrease in the number of securities sold. The decrease in other income is primarily due to decreases in miscellaneous income; gain on sale of land and OREO rental income. The increase in gains on loans held-for-sale was due to increased sales volume of loans held-for-sale. The increase in mortgage brokerage income and fiduciary activities income was primarily due to an increase in the demand for those services. The increase in ATM fees and signature based transaction fees is primarily due to an increase in the volume of transactions.

Other operating income was down 6.0% for the three-month period ended September 30, 2012 from the same period in 2011, decreasing from \$2,454,000 to \$2,306,000.

This decrease was primarily due to decreases in service charges on deposit accounts, investment and brokerage services income, gains on sales of available for sale securities, and other income, which was partially offset by increases in gains on loans held-for-sale, loan servicing income, fiduciary activities income, and signature based transaction fees. The decrease in service charges on deposit accounts is primarily due to decreases in service charges on checking accounts. The decrease in investment and brokerage services income was due to a decrease in the demand for those services. The decrease in gains on sales of available for sale securities is primarily due to a decrease in the number of securities sold. The decrease in other income is primarily due to decreases in miscellaneous income and gain on sale of land, partially offset by an increase in OREO rental income. The increase in gains on loans held-for-sale was due to increased sales volume of loans held-for-sale. The increase in loan servicing income is primarily due to an increase in mortgage servicing assets recorded, partially offset by an increase in impairment expense and amortization expense. The increase in fiduciary activities income was primarily due to an increase in the demand for those services. The increase in signature based transaction fees is primarily due to an increase in the volume of transactions.

## Other Operating Expenses

Total other operating expenses were down 2.6% for the nine-month period ended September 30, 2012 from the same period in 2011, decreasing from \$20,008,000 to \$19,488,000.

The decrease was primarily due to decreases in occupancy and equipment expense, advertising, and other real estate owned expense and impairment, which was partially offset by increases in salaries and employee benefits. The decrease in occupancy and equipment expense was primarily due to decreases in branch moving expenses, rent expense and utilities expense due to renegotiated leases. The decrease in advertising was due to decreases in printed materials and related costs. The decrease in other real estate owned expense and impairment was due to a decrease in write-downs and maintenance expenses. The increase in salaries and employee benefits was primarily due to increases in commissions, contingent compensation, and profit sharing expense, which was partially offset by a decrease in worker's compensation insurance expense.

Total other operating expenses were down 4.7% for the three-month period ended September 30, 2012 from the same period in 2011, decreasing from \$6,788,000 to \$6,470,000.

The decrease was primarily due to decreases in occupancy and equipment expense, data processing, advertising, other real estate owned expense and impairment, and other expenses, which was partially offset by an increase in stationery and supplies. The decrease in occupancy and equipment expense was primarily due to decreases in branch moving expenses, rent expense and utilities expense due to renegotiated leases. The decrease in data processing expenses was primarily due to decreases in general data processing costs. The decrease in advertising was due to decreases in printed materials and related costs. The decrease in other real estate owned expense and impairment was due to a decrease in write-downs and maintenance expenses. The decrease in other expenses is primarily due to decreases in consulting fees, postage, sundry losses, and loan collection expense, which was partially offset by an increase in loan origination expense. The increase in stationery and supplies was attributed to an increase in the usage of office supplies.

The following table sets forth other miscellaneous operating expenses by category for the three-month and nine-month periods ended September 30, 2012 and 2011.

|   | (in thousands)                                       |  |   |   |
|---|--|--|---|---|
|   | Three<br>months<br>Ended<br>September<br>30,<br>2012 | Three<br>months<br>ended<br>September<br>30,<br>2011 | Nine<br>months<br>ended<br>September<br>30,<br>2012 | Nine<br>months<br>ended<br>September<br>30,<br>2011 |
| Other miscellaneous operating expenses                      |  |  |   |   |
| Recovery of provision for unfunded loan commitments expense | \$—  | \$—  | \$—   | \$(24 )   |
| FDIC assessments  | 159  | 169  | 433   | 641   |
| Contributions   | 28   | 22   | 80  | 65  |
| Legal fees  | 41   | 43   | 168   | 170   |
| Accounting and audit fees                                   | 71   | 81   | 217   | 277   |
| Consulting fees   | 114  | 136  | 339   | 294   |
| Postage expense   | 46   | 71   | 214   | 263   |



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|   |                |                |                |                |
|---|----------------|----------------|----------------|----------------|
| Telephone expense                                   | 38             | 49             | 136            | 155            |
| Public relations                                    | 55             | 50             | 149            | 117            |
| Training expense                                    | 36             | 26             | 91             | 84             |
| Loan origination expense                            | 306            | 99             | 594            | 157            |
| Computer software depreciation                      | 34             | 41             | 110            | 127            |
| Sundry losses (recovery)                            | (27 )          | 94             | 14             | 110            |
| Loan collection expense                             | 23             | 56             | 134            | 150            |
| Other miscellaneous expense                         | 360            | 381            | 1,050          | 1,116          |
| <b>Total other miscellaneous operating expenses</b> | <b>\$1,284</b> | <b>\$1,318</b> | <b>\$3,729</b> | <b>\$3,702</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, 2012, the Company's expense for income taxes increased \$940,000 from the same period last year, from \$501,000 to \$1,441,000.

In the three months ended September 30, 2012, the Company's expense for income taxes increased \$329,000 from the same period last year, from \$255,000 to \$584,000.

The increase in expense 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, excludable interest income and, for California franchise taxes, higher excludable interest income on loans within designated enterprise zones.

## 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, 2012 | December<br>31, 2011 |
| Undisbursed loan commitments | \$155,209             | \$146,778            |
| Standby letters of credit    | 2,248                 | 1,872                |
| Commitments to sell loans    | 12,400                | 7,530                |
|                              | \$169,857             | \$156,180            |

The reserve for unfunded lending commitments amounted to \$793,000 at September 30, 2012 and December 31, 2011, respectively. The reserve for unfunded lending commitments is included in other liabilities.

## 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 and thrift 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, 2012, June 30, 2012, March 31, 2012, and December 31, 2011.

|                                | At September 30, 2012 |              |                | At June 30, 2012 |              |                |
|--------------------------------|-----------------------|--------------|----------------|------------------|--------------|----------------|
|                                | Gross                 | Guaranteed   | Net            | Gross            | Guaranteed   | Net            |
| (dollars in thousands)         |                       |              |                |                  |              |                |
| Residential mortgage           | \$2,136               | \$—          | \$2,136        | \$1,006          | \$—          | \$1,006        |
| Residential construction       | 42                    | —            | 42             | 42               | —            | 42             |
| Commercial real estate         | 3,628                 | —            | 3,628          | 4,057            | —            | 4,057          |
| Agriculture                    | —                     | —            | —              | 899              | —            | 899            |
| Commercial                     | 2,916                 | 116          | 2,800          | 3,042            | 124          | 2,918          |
| Consumer                       | 230                   | 51           | 179            | 236              | 52           | 184            |
| <b>Total non-accrual loans</b> | <b>\$8,952</b>        | <b>\$167</b> | <b>\$8,785</b> | <b>\$9,282</b>   | <b>\$176</b> | <b>\$9,106</b> |

|                          | At March 31, 2012 |            |       | At December 31, 2011 |            |         |
|--------------------------|-------------------|------------|-------|----------------------|------------|---------|
|                          | Gross             | Guaranteed | Net   | Gross                | Guaranteed | Net     |
| (dollars in thousands)   |                   |            |       |                      |            |         |
| Residential mortgage     | \$995             | \$—        | \$995 | \$1,334              | \$—        | \$1,334 |
| Residential construction | 203               | —          | 203   | 48                   | —          | 48      |
| Commercial real estate   | 3,481             | —          | 3,481 | 3,071                | —          | 3,071   |

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|                         |         |       |         |         |      |         |
|-------------------------|---------|-------|---------|---------|------|---------|
| Agriculture             | 991     | —     | 991     | 992     | —    | 992     |
| Commercial              | 3,123   | 62    | 3,061   | 2,905   | 62   | 2,843   |
| Consumer                | 422     | 54    | 368     | 360     | —    | 360     |
| Total non-accrual loans | \$9,215 | \$116 | \$9,099 | \$8,710 | \$62 | \$8,648 |

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 \$8,952,000 at September 30, 2012 and were comprised of seven residential mortgage loans totaling \$2,136,000, one residential construction loans totaling \$42,000, six commercial real estate loans totaling \$3,628,000, eleven commercial loans totaling \$2,916,000 and five consumer loans totaling \$230,000. Non-accrual loans amounted to \$8,710,000 at December 31, 2011 and were comprised of four residential mortgage loans totaling \$1,334,000, one residential construction loan totaling \$48,000, six commercial real estate loans totaling \$3,071,000, one agricultural loan totaling \$992,000, twelve commercial loans totaling \$2,905,000 and five consumer loans totaling \$360,000. 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, 2012, totaled approximately \$6,028,000 or 67% of total non-accrual loans and consisted of two commercial real estate loans totaling \$2,731,000, supported by commercial properties located within the Company's market area, two residential mortgage loans totaling \$1,494,000, supported by residential properties located within the Company's market area and one commercial and industrial loan totaling \$1,803,000, 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, 2011, totaled approximately \$6,181,000 or 71% of total non-accrual loans and consisted of one residential mortgage loan totaling \$726,000, supported by residential property located within the Company's market area, two commercial real estate loans totaling \$2,626,000, supported by commercial properties located within the Company's market area, one agricultural loan totaling \$992,000, supported by real property located within the Company's market area and one commercial and industrial loan totaling \$1,837,000, supported by the business assets of the borrower.

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, 2012 and December 31, 2011 consisting of loans on non-accrual status totaled \$8,952,000 and \$8,710,000, 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 totaled \$6,368,000 and \$9,516,000 at September 30, 2012 and December 31, 2011, respectively. Performing impaired loans at September 30, 2012 consist of loans modified as troubled debt restructurings totaling \$6,294,000 and other impaired loans totaling \$74,000 which the Company expects to collect all principal and interest due and are performing satisfactorily. Additionally, these loans are not on non-accrual status. The majority of the non-performing impaired loans were in management's opinion adequately collateralized based on recently obtained appraised property values or 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.

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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 \$289,000, or 2.9% to \$9,684,000 during the first nine months of 2012. Non-performing assets, net of guarantees, represent 1.2% of total assets at September 30, 2012.

|   | At September 30, 2012 |            |         | At June 30, 2012 |            |         |   |
|---|-----------------------|------------|---------|------------------|------------|---------|---|
|   | Gross                 | Guaranteed | Net     | Gross            | Guaranteed | Net     |   |
| (dollars in thousands)                                      |                       |            |         |                  |            |         |   |
| Non-accrual loans   | \$8,952               | \$167      | \$8,785 | \$9,282          | \$176      | \$9,106 |   |
| Loans 90 days past due and still accruing                   | —                     | —          | —       | —                | —          | —       |   |
| Total non-performing loans                                  | 8,952                 | 167        | 8,785   | 9,282            | 176        | 9,106   |   |
| Other real estate owned                                     | 899                   | —          | 899     | —                | —          | —       |   |
| Total non-performing assets                                 | 9,851                 | 167        | 9,684   | 9,282            | 176        | 9,106   |   |
| Non-performing loans to total loans                         |                       |            | 1.9     | %                |            | 2.0     | % |
| Non-performing assets to total assets                       |                       |            | 1.2     | %                |            | 1.2     | % |
| Allowance for loan and lease losses to non-performing loans |                       |            | 111.8   | %                |            | 107.5   | % |

|   | At March 31, 2012 |            |         | At December 31, 2011 |            |         |   |
|---|-------------------|------------|---------|----------------------|------------|---------|---|
|   | Gross             | Guaranteed | Net     | Gross                | Guaranteed | Net     |   |
| (dollars in thousands)                                      |                   |            |         |                      |            |         |   |
| Non-accrual loans   | \$9,215           | \$116      | \$9,099 | \$8,710              | \$62       | \$8,648 |   |
| Loans 90 days past due and still accruing                   | 29                | —          | 29      | —                    | —          | —       |   |
| Total non-performing loans                                  | 9,244             | 116        | 9,128   | 8,710                | 62         | 8,648   |   |
| Other real estate owned                                     | 1,618             | —          | 1,618   | 1,325                | —          | 1,325   |   |
| Total non-performing assets                                 | 10,862            | 116        | 10,746  | 10,035               | 62         | 9,973   |   |
| Non-performing loans to total loans                         |                   |            | 2.1     | %                    |            | 2.0     | % |
| Non-performing assets to total assets                       |                   |            | 1.4     | %                    |            | 1.3     | % |
| Allowance for loan and lease losses to non-performing loans |                   |            | 113.5   | %                    |            | 120.4   | % |

The Company had no loans 90 days past due and still accruing at September 30, 2012 and December 31, 2011.

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 \$899,000 and \$1,325,000 as of September 30, 2012 and December 31, 2011, respectively. The decrease in OREO at September 30, 2012 from the balance at December 31, 2011 was due to the sale of four properties partially offset by the addition of three properties.

## 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, 2012 and 2011, and for the year ended December 31, 2011.

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, |
|--|------------------------------------|-----------------|-------------------------------|
|  | 2012                               | 2011            | 2011                          |
| Balance at beginning of period                 | \$10,408                           | \$11,039        | \$11,039                      |
| Provision for loan losses                      | 2,051                              | 3,670           | 5,138                         |
| Loans charged-off:                             |                                    |                 |                               |
| Commercial                                     | (1,104 )                           | (911 )          | (2,381 )                      |
| Commercial Real Estate                         | (346 )                             | (1,414 )        | (2,000 )                      |
| Agriculture                                    | (115 )                             | (610 )          | (860 )                        |
| Residential mortgage                           | (864 )                             | (228 )          | (272 )                        |
| Residential construction                       | (161 )                             | (198 )          | (197 )                        |
| Consumer loans to individuals                  | (668 )                             | (681 )          | (932 )                        |
| <b>Total charged-off</b>                       | <b>(3,258 )</b>                    | <b>(4,042 )</b> | <b>(6,642 )</b>               |
| Recoveries:                                    |                                    |                 |                               |
| Commercial                                     | 278                                | 141             | 185                           |
| Commercial Real Estate                         | —                                  | 275             | 288                           |
| Agriculture                                    | 3                                  | 140             | 142                           |
| Residential mortgage                           | —                                  | 11              | 11                            |
| Residential construction                       | 260                                | 53              | 71                            |
| Consumer loans to individuals                  | 75                                 | 150             | 176                           |
| <b>Total recoveries</b>                        | <b>616</b>                         | <b>770</b>      | <b>873</b>                    |
| <b>Net charge-offs</b>                         | <b>(2,642 )</b>                    | <b>(3,272 )</b> | <b>(5,769 )</b>               |
| <b>Balance at end of period</b>                | <b>\$9,817</b>                     | <b>\$11,437</b> | <b>\$10,408</b>               |
| <b>Ratio of net charge-offs</b>                |                                    |                 |                               |
| To average loans outstanding during the period | (0.60 %)                           | (0.74 %)        | (1.34 %)                      |
| Allowance for loan losses                      |                                    |                 |                               |



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|   |       |   |       |   |       |   |
|---|-------|---|-------|---|-------|---|
| To total loans at the end of the period                             | 2.16  | % | 2.60  | % | 2.35  | % |
| To non-performing loans, net of guarantees at the end of the period | 111.8 | % | 233.4 | % | 120.4 | % |

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## Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2012, the Company had the following deposit mix: 31.0% in savings and MMDA deposits, 13.1% in time deposits, 24.8% in interest-bearing transaction deposits and 31.1% in non-interest-bearing transaction deposits. At December 31, 2011, the Company had the following deposit mix: 30.9% in savings and MMDA deposits, 15.7% in time deposits, 23.7% in interest-bearing transaction deposits and 29.7% 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, 2012 and December 31, 2011 are summarized as follows:

|                             | (in thousands)        |                      |
|-----------------------------|-----------------------|----------------------|
|                             | September<br>30, 2012 | December<br>31, 2011 |
| Three months or less        | \$17,482              | \$24,823             |
| Over three to twelve months | 30,939                | 37,170               |
| Over twelve months          | 7,855                 | 5,896                |
| Total                       | \$56,276              | \$67,889             |

The decrease in time certificates of deposit (CD's) of \$100,000 or more is primarily attributable to 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 63.9% on September 30, 2012. In addition, on September 30, 2012, the Company had the following short-term investments: \$2,175,000 in securities due within one year or less; and \$20,191,000 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 \$41,000,000 at September 30, 2012; additionally, the Company has a line of credit with the Federal Home Loan Bank (the "FHLB"), with a borrowing capacity at September 30, 2012 of \$144,443,000. The line of credit with FHLB is secured under terms of a blanket collateral agreement by a pledge of FHLB stock and certain other qualifying collateral such as commercial and mortgage loans.

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, 2012, 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, 2012.

(amounts in thousands except percentage amounts)

|                   | Actual   |       |   | Well Capitalized Ratio Requirement |   |
|-------------------|----------|-------|---|------------------------------------|---|
|                   | Capital  | Ratio |   |                                    |   |
| Leverage          | \$80,361 | 10.16 | % | 5.0                                | % |
| Tier 1 Risk-Based | \$80,361 | 16.35 | % | 6.0                                | % |
| Total Risk-Based  | \$86,547 | 17.65 | % | 10.0                               | % |

### 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, 2012, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011, 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, 2012. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended September 30, 2012, 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

In addition to the other information set forth in this report, you should carefully consider the risk factors set forth in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results and the following information:

The failure of the European Union to stabilize the fiscal condition and creditworthiness of its weaker member economies, such as Greece, Portugal, Spain, Hungary, Ireland, and Italy, could have international implications potentially impacting global financial institutions, the financial markets, and the economic recovery underway in the U.S.

Certain European Union member states have fiscal obligations greater than their fiscal revenue, which has caused investor concern over such countries ability to continue to service their debt and foster economic growth. Currently, the European debt crisis has caused credit spreads to widen in the fixed income debt markets, and liquidity to be less abundant. A weaker European economy may transcend Europe, cause investors to lose confidence in the safety and soundness of European financial institutions and the stability of European member economies, and likewise affect U.S.-based financial institutions, the stability of the global financial markets and the economic recovery underway in the U.S. Should the U.S. economic recovery be adversely impacted by these factors, loan and asset growth at U.S. financial institutions, like us, could be affected.

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

Not applicable.

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

Not applicable.

#### ITEM 4. – MINE SAFETY DISCLOSURES

Not applicable.

#### ITEM 5. – OTHER INFORMATION

Not applicable.

ITEM 6. – EXHIBITS

| Exhibit<br>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, 2012, is formatted in XBRL interactive data files: (i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statement of Stockholders’ Equity and Comprehensive Income; (iv) Condensed Consolidated Statements of Cash Flows; and (iv) 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.

\*\* In accordance with Rule 406T of Regulation S-T, the information furnished in these exhibits will not be deemed “filed” for purposes of Section 18 of the Exchange Act. Such exhibits will not be deemed to be incorporated by reference into any filing under the Securities Act or 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 8, 2012 By: /s/ Jeremiah Z. Smith

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