

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

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

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FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-30707

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

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

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

707-678-3041  
(Registrant's telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Yes  No

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

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

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

Yes  No

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

FIRST NORTHERN COMMUNITY BANCORP

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

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

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

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

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

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

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

See notes to unaudited condensed consolidated financial statements.



## FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except share data)

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

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

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

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

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014 and 2013 and December 31, 2013

1. BASIS OF PRESENTATION

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

Recently Issued Accounting Pronouncements:

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

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

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

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

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

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

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

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

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

#### Reclassifications

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

## 2. LOANS

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

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

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

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

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



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

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

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

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

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

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

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

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

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

## Non-accrual and Past Due Loans

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

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

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

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

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

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

## Impaired Loans

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

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

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

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

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

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

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

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

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

#### Troubled Debt Restructurings

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

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

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



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

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

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

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

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

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

## Credit Quality Indicators

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

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

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

## Allowance for Loan Losses

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

## Three-month period ended September 30, 2014

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

## Nine-month period ended September 30, 2014

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

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

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

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

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

Three-month period ended September 30, 2013

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

Nine-month period ended September 30, 2013

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

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

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

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

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

Year ended December 31, 2013

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

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

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

impairment

Loans

collectively

evaluated for

impairment

	103,341	227,206	49,657	47,197	8,599	54,967	490,967
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Ending Balance	\$ 106,751	\$ 230,284	\$ 49,657	\$ 52,844	\$ 9,554	\$ 55,870	\$ 504,960
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December 31, 2013

Loans

individually

evaluated for

impairment

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

collectively

evaluated for

impairment

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

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

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

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

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

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

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

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

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

Mortgage servicing rights, net of valuation allowance	\$1,968	\$170	\$(260	)	\$1,878
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At September 30, 2014 and December 31, 2013, the estimated fair market value of the Company's mortgage servicing rights asset was \$2,126,000 and \$2,326,000, respectively.

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

## 4. OUTSTANDING SHARES AND EARNINGS PER SHARE

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

## Earnings Per Share (EPS)

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

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

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

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

## 5. STOCK PLANS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

## 6. FAIR VALUE MEASUREMENT

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

### Fair Value Hierarchy

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

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

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

### Investment Securities Available-for-Sale

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

### Loans Held-for-Sale

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

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

#### Impaired Loans

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

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

#### Other Real Estate Owned

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

#### Loan Servicing Rights

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

## 7. PREFERRED STOCK

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

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

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

## 8. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

### Cash and Cash Equivalents

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

### Other Equity Securities

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

### Loans Receivable

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

### Loans Held-for-Sale

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



Interest Receivable and Payable

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

### Mortgage Servicing Rights

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

### Deposit Liabilities

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

### Limitations

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

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

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

Level	September 30, 2014		December 31, 2013	
	Carrying amount	Fair value	Carrying amount	Fair value