

FIRST NORTHERN COMMUNITY BANCORP  
Form 10-Q  
November 06, 2015  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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, 2015

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

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

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

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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 October 30, 2015 was 10,253,729.

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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 per share amounts)	September 30, 2015	December 31, 2014
Assets		
Cash and cash equivalents	\$261,314	\$216,192
Certificate of deposits	11,937	12,860
Investment securities – available-for-sale	134,582	151,226
Loans, net of allowance for loan losses of \$9,360 at September 30, 2015 and \$8,583 at December 31, 2014	591,503	537,979
Loans held-for-sale	1,241	491
Stock in Federal Home Loan Bank and other equity securities, at cost	3,934	3,934
Premises and equipment, net	7,015	7,278
Other real estate owned	-	736
Interest receivable and other assets	26,150	27,188
<b>Total Assets</b>	<b>\$1,037,676</b>	<b>\$957,884</b>
Liabilities and Stockholders' Equity		
Liabilities:		
Demand deposits	\$316,780	\$287,717
Interest-bearing transaction deposits	245,296	219,396
Savings and MMDA's	286,219	263,766
Time, under \$250,000	62,624	65,570
Time, \$250,000 and over	20,429	20,603
Total deposits	931,348	857,052
Interest payable and other liabilities	9,304	8,781
<b>Total Liabilities</b>	<b>940,652</b>	<b>865,833</b>
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, 2015 and December 31, 2014	12,847	12,847
Common stock, no par value; 16,000,000 shares authorized; 10,255,907 shares issued and outstanding at September 30, 2015 and 10,207,043 shares issued and outstanding at December 31, 2014	70,278	70,015
Additional paid-in capital	977	977
Retained earnings	13,144	8,146
Accumulated other comprehensive (loss) income, net	(222 )	66

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Total Stockholders' Equity	97,024	92,051
Total Liabilities and Stockholders' Equity	\$1,037,676	\$957,884

See notes to unaudited condensed consolidated financial statements.

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## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
(in thousands, except per share amounts)				
Interest and dividend income:				
Loans	\$ 7,480	\$ 6,717	\$ 21,280	\$ 19,795
Due from banks interest bearing accounts	145	132	465	411
Investment securities				
Taxable	631	741	2,066	2,232
Non-taxable	68	85	198	282
Other earning assets	97	77	395	205
Total interest and dividend income	8,421	7,752	24,404	22,925
Interest expense:				
Deposits	271	312	857	973
Total interest expense	271	312	857	973
Net interest income	8,150	7,440	23,547	21,952
Provision for loan losses	300	400	650	1,600
Net interest income after provision for loan losses	7,850	7,040	22,897	20,352
Non-Interest income:				
Service charges on deposit accounts	502	599	1,515	1,689
Gains on sales of loans held-for-sale	180	179	605	456
Investment and brokerage services income	154	158	449	479
Mortgage brokerage income	5	9	28	15
Loan servicing income	165	145	476	366
Fiduciary activities income	127	121	384	457
Debit card income	524	632	1,528	1,518
Gains on sales/calls of available-for-sale securities	29	53	29	53
Other income	155	208	580	647
Total non-interest income	1,841	2,104	5,594	5,680
Non-Interest expenses:				
Salaries and employee benefits	4,272	4,031	12,776	11,556
Occupancy and equipment	690	728	2,096	2,186
Data processing	410	434	1,257	1,265
Stationery and supplies	76	81	276	255
Advertising	67	84	239	257
Directors' fees	78	68	215	190
Other real estate owned (income) expense, net	(24 )	65	-	106
Gains on sales of other real estate owned	(55 )	-	(216 )	-
(Recovery) impairment on other interest earning asset	(12 )	-	(12 )	50
Other expense	1,393	1,301	4,049	3,880
Total non-interest expenses	6,895	6,792	20,680	19,745
Income before provision for income taxes	2,796	2,352	7,811	6,287
Provision for income taxes	977	782	2,705	2,014
Net income	\$ 1,819	\$ 1,570	\$ 5,106	\$ 4,273

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Preferred stock dividends	\$ (32 )	\$ (33 )	\$ (96 )	\$ (97 )
Net income available to common shareholders	\$ 1,787	\$ 1,537	\$ 5,010	\$ 4,176
Basic earnings per common share	\$ 0.18	\$ 0.15	\$ 0.49	\$ 0.41
Diluted earnings per common share	\$ 0.17	\$ 0.15	\$ 0.49	\$ 0.41

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
(in thousands)				
Net income	\$ 1,819	\$ 1,570	\$ 5,106	\$ 4,273
Other comprehensive (loss) income, net of tax:				
Unrealized holding gains (losses) arising during the period, net of tax effect of \$4 and \$(131) for the three months ended September 30, 2015 and September 30, 2014, respectively, and \$(157) and \$721 for the nine months ended September 30, 2015 and September 30, 2014, respectively	5	(196 )	(238 )	1,081
Less: reclassification adjustment due to gains realized on sales of securities, net of tax effect of \$(12) and \$(21) for the three months ended September 30, 2015 and September 30, 2014, respectively, and \$(12) and \$(21) for the nine months ended September 30, 2015 and September 30, 2014, respectively	(17 )	(32 )	(17 )	(32 )
Directors' and officer's retirements plan equity adjustments, net of tax effect of \$0 for the three months ended September 30, 2015 and September 30, 2014, and \$(22) and \$0 for the nine months ended September 30, 2015 and September 30, 2014, respectively	-	-	(33 )	-
Other comprehensive (loss) income	\$ (12 )	\$ (228 )	\$ (288 )	\$ 1,049
Comprehensive income	\$ 1,807	\$ 1,342	\$ 4,818	\$ 5,322

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, 2014	12,847	\$12,847	10,207,043	\$70,015	\$ 977	\$8,146	\$ 66	\$92,051
Net income						5,106		5,106
Other comprehensive loss							(288 )	(288 )
Stock dividend adjustment			682	6		(6 )		-
Dividend on preferred stock						(96 )		(96 )
Cash in lieu of fractional shares			(128 )			(6 )		(6 )
Stock-based compensation and related tax benefit				173				173
Common shares issued related to restricted stock grants			28,901					-
Restricted stock forfeited			(312 )					-
Stock options exercised			19,721	84				84
Balance at September 30, 2015	12,847	\$12,847	10,255,907	\$70,278	\$ 977	\$13,144	\$ (222 )	\$97,024

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, 2015	Nine months ended September 30, 2014
<b>Cash Flows From Operating Activities</b>		
Net income	\$5,106	\$ 4,273
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	496	504
Accretion and amortization of investment securities premiums and discounts, net	1,545	1,554
Decrease (increase) in deferred loan origination costs, net	295	(139 )
Provision for loan losses	650	1,600
Stock based compensation	173	139
Gains on calls/sales of available-for-sale securities	(29 )	(53 )
Impairment on other interest earning assets	-	50
Gains on sales of other real estate owned	(216 )	-
Impairment on other real estate owned	-	48
Gains on sales of loans held-for-sale	(605 )	(456 )
Proceeds from sales of loans held-for-sale	34,231	21,309
Originations of loans held-for-sale	(34,376 )	(20,848 )
Changes in assets and liabilities:		
Decrease in interest receivable and other assets	1,229	844
Net increase (decrease) in interest payable and other liabilities	468	(963 )
Net cash provided by operating activities	8,967	7,862
<b>Cash Flows From Investing Activities</b>		
Proceeds from call or maturities of available-for-sale securities	4,540	14,362
Proceeds from sales of available-for-sale securities	17,798	12,140
Principal repayments on available-for-sale securities	19,628	16,070
Purchase of available-for-sale securities	(27,262 )	(12,844 )
Net decrease in certificate of deposits	923	435
Net increase in loans	(54,876 )	(19,869 )
Net increase in stock in Federal Home Loan Bank and other equity securities, at cost	-	(267 )
Proceeds from sale of other real estate owned	1,359	414
Purchases of premises and equipment, net	(233 )	(382 )
Net cash (used in) provided by investing activities	(38,123 )	10,059
<b>Cash Flows From Financing Activities</b>		
Net increase in deposits	74,296	51,991
Cash dividends paid in lieu of fractional shares	(6 )	(6 )
Stock options exercised	84	-
Cash dividends paid on preferred stock	(96 )	(97 )
Net cash provided by financing activities	74,278	51,888
Net increase in Cash and Cash Equivalents	45,122	69,809
Cash and Cash Equivalents, beginning of period	216,192	165,447

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Cash and Cash Equivalents, end of period	\$261,314	\$235,256
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$840	\$958
Income taxes	\$2,525	\$1,213
Supplemental disclosures of non-cash investing and financing activities:		
Stock dividend distributed	\$3,103	\$2,065
Transfer of loans held-for-investment to other real estate owned	\$407	\$462
Directors' & Officer's Retirement Plan Equity Adj, net of tax	\$(33)	) \$-
Unrealized (losses) gains on available for sale securities, net of taxes	\$(255)	) \$1,049

See notes to unaudited condensed consolidated financial statements.

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FIRST NORTHERN COMMUNITY BANCORP

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2015 and 2014 and December 31, 2014

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, 2014 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 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 adoption of this update did not have a significant impact on the Company's 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 adoption of this update did not have a significant impact on the Company's 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 adoption of this update did not have a significant impact on the Company's 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. The adoption of this update did not have a significant impact on the Company's consolidated financial statements.

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 the Company's consolidated financial statements.

In April 2015, FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The amendments in ASU 2015-03 are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. Effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The Company does not expect the adoption of this update to have a significant impact on the Company's consolidated financial statements.

In June 2015, FASB issued ASU 2015-10, Technical Corrections and Improvements. The amendments in ASU 2015-10 represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. In addition, some of the amendments are intended to make the Codification easier to understand and easier to apply by eliminating inconsistencies, providing needed clarifications, and improving the presentation of guidance in the Codification. The amendments that require transition guidance are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. All other amendments will be effective upon issuance. The Company does not expect the adoption of this update to have a significant impact on the Company's consolidated financial statements.

Reclassifications

Certain reclassifications have been made to prior period balances in order to conform to the current year presentation. There was no impact to the net income, earnings per share, or stockholders' equity as a result of reclassifications.

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## 2. LOANS

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

(\$ in thousands)	September 30, 2015	December 31, 2014
Commercial	\$ 129,614	\$ 120,751
Commercial Real Estate	296,421	256,955
Agriculture	74,138	61,144
Residential Mortgage	42,666	50,511
Residential Construction	11,313	5,963
Consumer	45,679	49,911
	599,831	545,235
Allowance for loan losses	(9,360 )	(8,583 )
Net deferred origination costs	1,032	1,327
Loans, net	\$ 591,503	\$ 537,979

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, 2015, approximately 49% in principal amount of the Company's loans were secured by commercial real estate, consisting primarily of loans secured by commercial properties and construction and land development loans. Approximately 7% in principal amount of the Company's loans were residential mortgage loans. Approximately 2% in principal amount of the Company's loans were residential construction loans. Approximately 12% 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 8% 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, 2015 and December 31, 2014, 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, 2015 and December 31, 2014 were as follows:

(\$ in thousands)	September 30, 2015	December 31, 2014
Commercial	\$ 129	\$ 2,151
Commercial Real Estate	1,281	672
Agriculture	—	—
Residential Mortgage	575	1,691
Residential Construction	58	71
Consumer	563	652
	\$ 2,606	\$ 5,237

Non-accrual loans amounted to \$2,606,000 at September 30, 2015 and were comprised of four commercial loans totaling \$129,000, five commercial real estate loans totaling \$1,281,000, three residential mortgage loans totaling \$575,000, one residential construction loan totaling \$58,000 and four consumer loans totaling \$563,000. Non-accrual loans amounted to \$5,237,000 at December 31, 2014 and were comprised of six residential mortgage loans totaling \$1,691,000, two residential construction loans totaling \$71,000, five commercial real estate loans totaling \$672,000, seven commercial loans totaling \$2,151,000, and five consumer loans totaling \$652,000. 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, 2015 and December 31, 2014, 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
September 30, 2015						
Commercial	\$245	\$—	\$57	\$302	\$129,312	\$129,614
Commercial Real Estate	—	136	774	910	295,511	296,421
Agriculture	—	—	—	—	74,138	74,138
Residential Mortgage	320	434	125	879	41,787	42,666
Residential Construction	464	65	—	529	10,784	11,313
Consumer	8	—	428	436	45,243	45,679
Total	\$1,037	\$635	\$1,384	\$3,056	\$596,775	\$599,831
December 31, 2014						
Commercial	\$—	\$—	\$82	\$82	\$120,669	\$120,751
Commercial Real Estate	—	—	239	239	256,716	256,955
Agriculture	—	—	—	—	61,144	61,144
Residential Mortgage	1,172	—	457	1,629	48,882	50,511
Residential Construction	—	—	—	—	5,963	5,963
Consumer	2	1	472	475	49,436	49,911
Total	\$1,174	\$1	\$1,250	\$2,425	\$542,810	\$545,235

The Company had no loans that were 90 days or more past due and still accruing at September 30, 2015 and December 31, 2014. Included in the aging loan category labeled "current" are non-accrual loans that were not delinquent with respect to contractual principal and interest payments as of September 30, 2015 and December 31, 2014. These loans are categorized as non-accrual loans and are not accruing interest as of September 30, 2015 and December 31, 2014. Non-accrual loans outstanding at September 30, 2015 and December 31, 2014 are disclosed in the table above.

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, 2015 and December 31, 2014 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, 2015					
Commercial	\$ 973	\$ 113	\$ 846	\$ 959	\$ 51
Commercial Real Estate	1,578	1,281	297	1,578	42
Agriculture	—	—	—	—	—
Residential Mortgage	3,593	576	2,784	3,360	619
Residential Construction	987	58	802	860	114
Consumer	1,634	634	695	1,329	26
Total	\$ 8,765	\$ 2,662	\$ 5,424	\$ 8,086	\$ 852
December 31, 2014					
Commercial	\$ 2,803	\$ 2,147	\$ 531	\$ 2,678	\$ 39
Commercial Real Estate	990	672	304	976	45
Agriculture	—	—	—	—	—
Residential Mortgage	5,666	1,691	2,956	4,647	646
Residential Construction	1,065	71	826	897	107
Consumer	1,506	780	726	1,506	23
Total	\$ 12,030	\$ 5,361	\$ 5,343	\$ 10,704	\$ 860

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the three months ended September 30, 2015 and September 30, 2014 was as follows:

(\$ in thousands)	Three Months Ended September 30, 2015		Three Months Ended September 30, 2014	
	Average Recorded Investment	Average Interest Recognized	Average Interest Recognized	Average Interest Recognized
Commercial	\$1,840	\$ 13	\$2,993	\$ 9
Commercial Real Estate	1,392	30	2,930	20
Agriculture	—	—	—	—
Residential Mortgage	3,587	38	5,293	32
Residential Construction	866	8	914	9

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Consumer	1,351	10	1,500	11
Total	\$9,036	\$ 99	\$13,630	\$ 81

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The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the nine months ended September 30, 2015 and September 30, 2014 was as follows:

(\$ in thousands)	Nine Months Ended September 30, 2015		Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	\$2,234	\$ 33	\$4,039	\$ 19
Commercial Real Estate	1,180	38	3,320	58
Agriculture	—	—	655	—
Residential Mortgage	4,104	96	5,389	96
Residential Construction	879	27	925	29
Consumer	1,423	29	1,482	40
Total	\$9,820	\$ 223	\$15,810	\$ 242

None of the interest on impaired loans was recognized using a cash basis of accounting for the three and nine months ended September 30, 2015 and September 30, 2014.

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 \$5,621,000 and \$6,712,000 in TDR loans as of September 30, 2015 and December 31, 2014, respectively. Specific reserves for TDR loans totaled \$852,000 and \$860,000 as of September 30, 2015 and December 31, 2014, respectively. TDR loans performing in compliance with modified terms totaled \$5,480,000 and \$5,467,000 as of September 30, 2015 and December 31, 2014, respectively. There were no commitments to advance more funds on existing TDR loans as of September 30, 2015.



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There were no loans modified as troubled debt restructurings during the three-month periods ended September 30, 2015 and September 30, 2014.

Loans modified as TDRs during the nine months ended September 30, 2015 and September 30, 2014 were as follows:

	Nine Months Ended September (\$ in thousands) 30, 2015		Post- modification outstanding recorded investment
	Number of recorded Contracts	Pre-modification outstanding recorded investment	
Commercial	1	\$ 419	\$ 419
Consumer	1	109	109
Total	2	\$ 528	\$ 528

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

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. There were no loans modified as a TDR within the previous 12 months and for which there was a payment default during the three and nine months ended September 30, 2015. 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.

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 an 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, 2014.

The following table presents the risk ratings by loan class as of September 30, 2015 and December 31, 2014:

(\$ in thousands)	Pass	Special Mention	Substandard	Doubtful	Loss	Total
September 30, 2015						
Commercial	\$116,571	\$11,547	\$1,496	\$ —	\$ —	\$129,614
Commercial Real Estate	275,822	16,618	3,981	—	—	296,421
Agriculture	74,138	—	—	—	—	74,138
Residential Mortgage	41,511	376	779	—	—	42,666
Residential Construction	10,732	458	123	—	—	11,313
Consumer	43,570	348	1,761	—	—	45,679
Total	\$562,344	\$29,347	\$8,140	\$ —	\$ —	\$599,831
December 31, 2014						
Commercial	\$112,751	\$3,255	\$4,745	\$ —	\$ —	\$120,751
Commercial Real Estate	240,808	10,607	5,540	—	—	256,955
Agriculture	61,144	—	—	—	—	61,144
Residential Mortgage	46,043	997	3,471	—	—	50,511
Residential Construction	5,386	467	110	—	—	5,963
Consumer	46,234	944	2,733	—	—	49,911
Total	\$512,366	\$16,270	\$16,599	\$ —	\$ —	\$545,235

Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2015.

## Three months ended September 30, 2015

(\$ in thousands)	Commercial Real		Residential		Residential		Unallocated	Total
	Commercial	Estate	Agriculture	Mortgage	Construction	Consumer		
Balance as of June 30, 2015	\$ 3,259	\$ 2,888	\$ 852	\$ 833	\$ 144	\$ 647	\$ 483	\$9,106
Provision for loan losses	(128 )	454	75	(98 )	171	57	(231 )	300
Charge-offs	(14 )	—	—	—	—	(67 )	—	(81 )
Recoveries	3	13	—	1	1	17	—	35
Net charge-offs	(11 )	13	—	1	1	(50 )	—	(46 )
Balance as of September 30, 2015	\$ 3,120	\$ 3,355	\$ 927	\$ 736	\$ 316	\$ 654	\$ 252	\$9,360

## Nine months ended September 30, 2015

(\$ in thousands)	Commercial Real		Residential		Residential		Unallocated	Total
	Commercial	Estate	Agriculture	Mortgage	Construction	Consumer		
Balance as of December 31, 2014	\$ 3,581	\$ 1,825	\$ 580	\$ 1,181	\$ 161	\$ 886	\$ 369	\$8,583
Provision for loan losses	(537 )	1,513	347	(529 )	97	(124 )	(117 )	650
Charge-offs	(14 )	—	—	(132 )	—	(152 )	—	(298 )
Recoveries	90	17	—	216	58	44	—	425
Net recoveries	76	17	—	84	58	(108 )	—	127
Balance as of September 30, 2015	\$ 3,120	\$ 3,355	\$ 927	\$ 736	\$ 316	\$ 654	\$ 252	\$9,360

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, 2015.

(\$ in thousands)	Commercial Real		Residential		Residential		Unallocated	Total
	Commercial	Estate	Agriculture	Mortgage	Construction	Consumer		
Period-end amount allocated to:								
Loans individually evaluated for impairment	\$ 51	\$ 42	\$ —	\$ 619	\$ 114	\$ 26	\$ —	\$852
Loans collectively evaluated for impairment	3,069	3,313	927	117	202	628	252	8,508
Ending Balance	\$ 3,120	\$ 3,355	\$ 927	\$ 736	\$ 316	\$ 654	\$ 252	\$9,360

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The following table details activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2014.

Three months ended September 30, 2014

(\$ in thousands)	Commercial		Residential				Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Construction	Consumer		
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 months ended September 30, 2014

(\$ in thousands)	Commercial		Residential				Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Construction	Consumer		
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				Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Construction	Consumer		
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

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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 year ended December 31, 2014.

Year ended December 31, 2014

(\$ in thousands)	Commercial		Agriculture	Residential		Consumer	Unallocated	Total
	Commercial	Real Estate		Mortgage	Construction			
Balance as of December 31, 2013	\$ 3,199	\$ 2,290	\$ 557	\$ 1,216	\$ 441	\$ 1,023	\$ 627	\$ 9,353
Provision for (reversal of) loan losses	2,612	(396 )	23	36	(366 )	149	(258 )	1,800
Charge-offs	(2,288 )	(69 )	—	(71 )	—	(393 )	—	(2,821)
Recoveries	58	—	—	—	86	107	—	251
Net charge-offs	(2,230 )	(69 )	—	(71 )	86	(286 )	—	(2,570)
Ending Balance	\$ 3,581	\$ 1,825	\$ 580	\$ 1,181	\$ 161	\$ 886	\$ 369	\$ 8,583
Period-end amount allocated to:								
Loans individually evaluated for impairment	\$ 39	\$ 45	\$ —	\$ 646	\$ 107	\$ 23	\$ —	\$ 860
Loans collectively evaluated for impairment	3,542	1,780	580	535	54	863	369	7,723
Balance as of December 31, 2014	\$ 3,581	\$ 1,825	\$ 580	\$ 1,181	\$ 161	\$ 886	\$ 369	\$ 8,583

The Company's investment in loans as of September 30, 2015, September 30, 2014, and December 31, 2014 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	Construction		
September 30, 2015							
Loans individually evaluated for impairment	\$ 959	\$ 1,578	\$ —	\$ 3,360	\$ 860	\$ 1,329	\$ 8,086
Loans collectively evaluated for impairment	128,655	294,843	74,138	39,306	10,453	44,350	591,745
Ending Balance	\$ 129,614	\$ 296,421	\$ 74,138	\$ 42,666	\$ 11,313	\$ 45,679	\$ 599,831
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
December 31, 2014							
Loans individually evaluated for impairment	\$ 2,678	\$ 976	\$ —	\$ 4,647	\$ 897	\$ 1,506	\$ 10,704
Loans collectively evaluated for impairment	118,073	255,979	61,144	45,864	5,066	48,405	534,531
Ending Balance	\$ 120,751	\$ 256,955	\$ 61,144	\$ 50,511	\$ 5,963	\$ 49,911	\$ 545,235



### 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, 2015 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 non-interest income on the condensed consolidated statements of income.

Key assumptions used in measuring the fair value of mortgage servicing rights as of September 30, 2015 and December 31, 2014 were as follows:

	September 30, 2015		December 31, 2014	
Constant prepayment rate	11.38	%	12.12	%
Discount rate	10.55	%	10.06	%
Weighted average life (years)	6.33		6.25	

At September 30, 2015 and December 31, 2014, the Company's mortgage loans held-for-sale were \$1,241,000 and \$491,000, respectively. At September 30, 2015, and December 31, 2014, the Company serviced real estate mortgage loans for others totaling \$237,903,000 and \$238,974,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2015 and December 31, 2014. Mortgage servicing rights are included in Interest Receivable and Other Assets on the condensed consolidated balance sheets:

	(in thousands)			
	December 31, 2014	Additions	Reductions	September 30, 2015
Mortgage servicing rights	\$ 1,862	\$ 304	\$ (277)	) \$ 1,889
Valuation allowance	—	—	—	—
Mortgage servicing rights, net of valuation allowance	\$ 1,862	\$ 304	\$ (277)	) \$ 1,889

At September 30, 2015 and December 31, 2014, the estimated fair value of the Company's mortgage servicing rights asset was \$2,019,000 and \$2,068,000, respectively.

The Company received contractually specified servicing fees of \$150,000 and \$152,000 for the three months ended September 30, 2015 and September 30, 2014, respectively. The Company received contractually specified servicing fees of \$450,000 and \$456,000 for the nine months ended September 30, 2015 and September 30, 2014, respectively. Contractually specified servicing fees are included in non-interest income on the condensed consolidated statements of income, net of the amortization of the mortgage servicing rights asset.



## 4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 22, 2015, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2015. 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. 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. 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 and nine months ended September 30, 2015 and 2014.

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Basic earnings per share:				
Net income	\$1,819	\$1,570	\$5,106	\$4,273
Preferred stock dividend	\$(32)	\$(33)	\$(96)	\$(97)
Net income available to common stockholders	\$1,787	\$1,537	\$5,010	\$4,176
Weighted average common shares outstanding	10,170,848	10,119,433	10,159,119	10,114,976
Basic EPS	\$0.18	\$0.15	\$0.49	\$0.41
Diluted earnings per share:				
Net income	\$1,819	\$1,570	\$5,106	\$4,273
Preferred stock dividend	\$(32)	\$(33)	\$(96)	\$(97)
Net income available to common stockholders	\$1,787	\$1,537	\$5,010	\$4,176
Weighted average common shares outstanding	10,170,848	10,119,433	10,159,119	10,114,976
Effect of dilutive shares	57,036	54,538	56,300	51,515
Adjusted weighted average common shares outstanding	10,227,884	10,173,971	10,215,419	10,166,491
Diluted EPS	\$0.17	\$0.15	\$0.49	\$0.41

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 157,489 shares and 229,286 shares for the three months ended September 30, 2015 and 2014, 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 168,321 shares and 245,582 shares for the nine months ended September 30, 2015 and 2014, 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 months ended September 30, 2015 and 2014. 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 zero shares and 8,533 shares for the nine months ended September 30, 2015 and 2014, respectively.



## 5. STOCK PLANS

On January 22, 2015, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2015. 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, 2015.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
Options outstanding at Beginning of Period	228,693	\$ 11.49		
Granted	—	—		
Expired	(6,832 )	\$ 17.18		
Cancelled / Forfeited	—	—		
Exercised	—	—		
Options outstanding at End of Period	221,861	\$ 11.32	\$243,197	4.58
Exercisable (vested) at End of Period	150,212	\$ 13.39	\$172,559	2.62

The following table presents the activity related to stock options for the nine months ended September 30, 2015.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
Options outstanding at Beginning of Period	313,483	\$ 11.54		
Granted	41,047	\$ 7.60		
Expired	(101,441 )	\$ 11.35		
Cancelled / Forfeited	(11,382 )	\$ 16.28		
Exercised	(19,846 )	\$ 4.23		
Options outstanding at End of Period	221,861	\$ 11.32	\$243,197	4.58
Exercisable (vested) at End of Period	150,212	\$ 13.39	\$172,559	2.62

The weighted average grant date fair value per share of options granted during the nine months ended September 30, 2015 was \$2.67 per share.

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As of September 30, 2015, there was \$150,000 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 2.79 years.

There was \$48,000 of recognized compensation cost related to stock options granted for the nine months ended September 30, 2015.

A summary of the weighted average assumptions used in valuing stock options during the three and nine months ended September 30, 2015 is presented below.

	Three Months Ended September 30, 2015*	Nine Months Ended September 30, 2015	
Risk Free Interest Rate	—	1.61	%
Expected Dividend Yield	—	0.00	%
Expected Life in Years	—	5	
Expected Price Volatility	—	37.38	%

\*There were no stock options granted during the three months ended September 30, 2015.

The following table presents the activity related to non-vested restricted stock for the three months ended September 30, 2015.

	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	85,579	\$ 6.54		
Granted	—	—		
Cancelled / Forfeited	(312 )	\$ 7.60		
Exercised/Released/Vested	—	—		
Non-vested restricted stock outstanding at End of Period	85,267	\$ 6.53	\$ 677,873	8.24

The following table presents the activity related to non-vested restricted stock for the nine months ended September 30, 2015.

	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	73,827	\$ 5.64		
Granted	30,056	\$ 7.59		
Cancelled / Forfeited	(312 )	\$ 7.60		

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Exercised/Released/Vested	(18,304)	\$ 4.66		
Non-vested restricted stock outstanding at End of Period	85,267	\$ 6.53	\$677,873	8.24

The weighted average fair value of restricted stock granted during the nine months ended September 30, 2015 was \$7.59 per share.

As of September 30, 2015, there was \$328,000 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 \$107,000 of recognized compensation cost related to restricted stock awards for the nine months ended September 30, 2015.

The Company has an Employee Stock Purchase Plan ("ESPP"). Under the ESPP, the Company is authorized to issue shares of common stock to eligible employees. There are 322,385 (adjusted for the March 2015 stock dividend) shares authorized under the 2006 Amended ESPP. The 2006 Amended ESPP will expire on March 15, 2016. In May 2015, the Company's shareholders approved the 2016 ESPP, which will become effective on March 16, 2016. There are 250,000 shares authorized under the 2016 ESPP, which include authorized but unissued shares under the 2006 Amended ESPP. The 2016 ESPP will expire on March 16, 2026. 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, 2014 to November 23, 2015. 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, 2015, 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 \$19,000 of recognized compensation cost related to ESPP issuances for the nine months ended September 30, 2015.

The weighted average fair value at issuance date during the nine months ended September 30, 2015 was \$1.67.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three and nine months ended September 30, 2015 is presented below.

	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
Risk Free Interest Rate	0.14	%	0.14	%
Expected Dividend Yield	0.00	%	0.00	%
Expected Life in Years	1.00		1.00	
Expected Price Volatility	15.10	%	15.10	%

## 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, 2015 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, 2015, 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, 2015:

	(in thousands)			
	Total	Level 1	Level 2	Level 3
September 30, 2015				
Securities of U.S. government agencies and corporations	\$13,189	\$ —	\$13,189	\$ —
Obligations of states and political subdivisions	20,845	—	20,845	—
Collateralized mortgage obligations	11,857	—	11,857	—
Mortgage-backed securities	88,691	—	88,691	—
Total investments at fair value	\$134,582	\$ —	\$134,582	\$ —

There were no transfers of assets measured at fair value on a recurring basis between Level 1 and Level 2 of the fair value hierarchy.

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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, 2014:

	(in thousands)			
	Total	Level 1	Level 2	Level 3
December 31, 2014				
Securities of U.S. government agencies and corporations	\$28,429	\$ —	\$28,429	\$ —
Obligations of states and political subdivisions	20,763	—	20,763	—
Collateralized mortgage obligations	12,553	—	12,553	—
Mortgage-backed securities	89,481	—	89,481	—
Total investments at fair value	\$151,226	\$ —	\$151,226	\$ —

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, 2015:

	(in thousands)			
	Total	Level 1	Level 2	Level 3
September 30, 2015				
Impaired loans	\$69	—	—	\$69
Total assets at fair value	\$69	\$ —	\$ —	\$69

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, 2014:

	(in thousands)			
	Total	Level 1	Level 2	Level 3
December 31, 2014				
Impaired loans	\$568	\$ —	\$ —	\$568
Other real estate owned	736	—	—	736
Total assets at fair value	\$1,304	\$ —	\$ —	\$1,304

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2015 and December 31, 2014.

Key methods and assumptions used in measuring the fair value of impaired loans and OREO as of September 30, 2015 and December 31, 2014 were as follows:

	Method	Assumption Inputs
Impaired loans	Collateral, market, income, enterprise, liquidation and discounted Cash Flows	External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 7%.
Other real estate owned	Collateral	External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 11%.



## 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.

On October 26, 2015, the Company redeemed the remaining \$12,847,000 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 & Cash Equivalents and Certificates of Deposit

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 & cash equivalents and certificates of deposit are derived from Level 1 inputs.

### Stock in Federal Home Loan Bank and other equity securities, at cost

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 Note 6, Fair Value Measurement included in these notes to unaudited condensed consolidated financial statements.

### Mortgage Servicing Rights

The Company measures fair value of mortgage servicing rights using Level 2 and Level 3 inputs. 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.

### 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.

### 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, 2015 and December 31, 2014 are approximately as follows:

		September 30, 2015		December 31, 2014	
	Level	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:					
Cash and cash equivalents	1	\$261,314	\$261,314	\$216,192	\$216,192
Certificates of deposit	1	11,937	11,937	12,860	12,860
Stock in FHLB and other equity securities, at cost	2	3,934	3,934	3,934	3,934
Loans receivable:					
Net loans	3	591,503	588,749	537,979	535,018
Loans held-for-sale	2	1,241	1,277	491	509
Interest receivable	2	2,911	2,911	2,650	2,650
Mortgage servicing rights	3	1,889	2,019	1,862	2,068
Financial liabilities:					
Deposits	3	931,348	901,623	857,052	837,150
Interest payable	2	87	87	70	70

## 9. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2015 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
Securities of U.S. government agencies and corporations	\$ 13,158	\$ 44	\$ (13 )	\$ 13,189
Obligations of states and political subdivisions	20,378	483	(16 )	20,845
Collateralized mortgage obligations	11,791	67	(1 )	11,857
Mortgage-backed securities	88,508	494	(311 )	88,691
Total debt securities	\$ 133,835	\$ 1,088	\$ (341 )	\$ 134,582

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2014 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
Securities of U.S. government agencies and corporations	\$ 28,787	\$ 17	\$ (375 )	\$ 28,429
Obligations of states and political subdivisions	20,236	579	(52 )	20,763
Collateralized mortgage obligations	12,541	37	(25 )	12,553
Mortgage-backed securities	88,491	1,144	(154 )	89,481
Total debt securities	\$ 150,055	\$ 1,777	\$ (606 )	\$ 151,226

The Company had \$17,798,000 in proceeds from sales of available-for-sale securities for each of the three and nine months ended September 30, 2015. The Company had \$12,140,000 in proceeds from sales of available-for-sale securities for each of the three and nine months ended September 30, 2014. Gross realized gains from sales or calls of available-for-sale securities were \$68,000 for each of the three and nine months ended September 30, 2015. Gross realized gains from sales or calls of available-for-sale securities were \$292,000 for each of the three and nine months ended September 30, 2014. Gross realized losses from sales or calls of available-for-sale securities were \$39,000 for each of the three and nine months ended September 30, 2015. Gross realized losses from sales or calls of available-for-sale securities were \$239,000 for each of the three and nine months ended September 30, 2014. There was a \$12,000 recovery from other equity securities for each of the three months and nine months ended September 30, 2015. There was \$0 and \$50,000 gross realized loss from other equity securities for the three months and nine months ended September 30, 2014, respectively.

The amortized cost and estimated fair value of debt and other securities at September 30, 2015, by contractual and expected maturity, are shown in the following table:

(in thousands)	Amortized cost	Estimated fair value
Due in one year or less	\$ 4,566	\$ 4,577
Due after one year through five years	117,480	117,898



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Due after five years through ten years	10,565	10,844
Due after ten years	1,224	1,263
	\$ 133,835	\$ 134,582

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Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities due after one year through five years included mortgage-backed securities and collateralized mortgage obligations with expected maturities totaling \$99,469,000 at September 30, 2015. 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, 2015, 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	\$-	\$ -	\$6,089	\$ (13 )	\$6,089	\$ (13 )
Obligations of states and political subdivisions	1,703	(16 )	-	-	1,703	(16 )
Collateralized Mortgage obligations	486	(1 )	-	-	486	(1 )
Mortgaged-backed securities	37,212	(219 )	6,233	(92 )	43,445	(311 )
Total	\$39,401	\$ (236 )	\$12,322	\$ (105 )	\$51,723	\$ (341 )

No decline in value was considered "other-than-temporary" during the first nine months of 2015. Thirty-nine securities, all considered investment grade, which had a fair value of \$39,401,000 and a total unrealized loss of \$236,000, have been in an unrealized loss position for less than twelve months as of September 30, 2015. Twelve securities, all considered investment grade, which had a fair value of \$12,322,000 and a total unrealized loss of \$105,000, have been in an unrealized loss position for more than twelve months as of September 30, 2015. The declines in fair value were attributable to changes in interest rates. We have evaluated the credit ratings of our investment securities and their issuer and/or insurers, and based on this evaluation have determined that no investment security in our investment portfolio is other-than-temporarily impaired. As the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities prior to their anticipated recovery, these investments are not considered other-than-temporarily impaired.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2014, follows:

	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	\$1,474	\$ (4 )	\$21,729	\$ (371 )	\$23,203	\$ (375 )
Obligations of states and political subdivisions	1,927	(28 )	1,530	(24 )	3,457	(52 )
Collateralized Mortgage obligations	2,881	(25 )	—	—	2,881	(25 )
Mortgage-backed securities	9,786	(55 )	9,128	(99 )	18,914	(154 )
Total	\$16,068	\$ (112 )	\$32,387	\$ (494 )	\$48,455	\$ (606 )

Investment securities carried at \$30,902,000 and \$27,868,000 at September 30, 2015 and December 31, 2014, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.



## 10. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table details activity in accumulated other comprehensive loss for the three months ended September 30, 2015.

(\$ in thousands)	Unrealized Gains on Securities	Officers' retirement plan	Directors' retirement plan	Accumulated Other Comprehensive Income/(loss)
Balance as of June 30, 2015	\$ 460	\$ (678 )	\$ 8	\$ (210 )
Current period other comprehensive loss	(12 )	—	—	(12 )
Balance as of September 30, 2015	\$ 448	\$ (678 )	\$ 8	\$ (222 )

The following table details activity in accumulated other comprehensive income (loss) for the nine months ended September 30, 2015.

(\$ in thousands)	Unrealized Gains on Securities	Officers' retirement plan	Directors' retirement plan	Accumulated Other Comprehensive Income/(loss)
Balance as of December 31, 2014	\$ 703	\$ (678 )	\$ 41	\$ 66
Current period other comprehensive loss	(255 )	—	(33 )	(288 )
Balance as of September 30, 2015	\$ 448	\$ (678 )	\$ 8	\$ (222 )

The following table details activity in accumulated other comprehensive income (loss) for the three months ended September 30, 2014.

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

The following table details activity in accumulated other comprehensive loss for the nine months ended September 30, 2014.

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

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

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

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

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

(in thousands)	September 30, 2015	December 31, 2014
Undisbursed loan commitments	\$ 206,225	\$ 171,019
Standby letters of credit	2,972	2,099
Commitments to sell loans	2,137	1,230
	\$ 211,334	\$ 174,348

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank issues both financial and performance standby letters of credit. The financial standby letters of credit are primarily to guarantee payment to third parties. At September 30, 2015, there were no financial standby letters of credit outstanding. The performance standby letters of credit are typically issued to municipalities as specific performance bonds. At September 30, 2015, there was \$2,972,000 issued in performance standby letters of credit. At September 30, 2015, the Bank had experienced no draws on these letters of credit, resulting in no related liability included on its balance sheet, however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of \$793,000 at September 30, 2015, which is recorded in "interest payable and other liabilities" on the Condensed Consolidated Balance Sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of September 30, 2015, the Company had no off-balance sheet derivatives requiring additional disclosure.

Mortgage loans sold to investors may be sold with servicing rights retained, for which the Company makes only standard legal representations and warranties as to meeting certain underwriting and collateral documentation

standards. In the past two years, the number of loans the Company has had to repurchase due to deficiencies in underwriting or loan documentation was not significant. Management believes that any liabilities that may result from such recourse provisions are not significant.

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

FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements, which may include forecasts of our financial results and condition, expectations for our operations and business, and our assumptions for those forecasts and expectations. Do not rely unduly on forward-looking statements. Actual results might differ significantly compared to our forecasts and expectations. See Part I, Item 1A. "Risk Factors," and the other risks described in our 2014 Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q for factors to be considered when reading any forward-looking statements in this filing.

This report and other reports or statements which we may release includes forward-looking statements, which are subject to the "safe harbor" created by section 27A of the Securities Act of 1933, as amended, and section 21E of the Securities Exchange Act of 1934, as amended. We may make forward-looking statements in our Securities and Exchange Commission (SEC) filings, press releases, news articles and when we are speaking on behalf of the Company. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include the words "believe," "expect," "target," "anticipate," "intend," "plan," "seek," "strive," "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 any forward-looking statements are made.

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

Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position and prospects, and the affect of competition on our business and strategies

Our assessment of significant factors and developments that have affected or may affect our results

Pending and recent legal and regulatory actions, and future legislative and regulatory developments, including the effects of the Dodd-Frank Wall Street Reform and Protection Act (the "Dodd-Frank Act") and other legislation and governmental measures introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy

Regulatory and compliance controls, processes and requirements and their impact on our business

The costs and effects of legal or regulatory actions

Expectations regarding draws on performance letters of credit

Our regulatory capital requirements, including the recently adopted capital rules by the U.S. federal banking agencies

Expectations regarding our non-payment of a cash dividend on our common stock in the foreseeable future





Credit quality and provision for credit losses and management of asset quality and credit risk

Our allowances for credit losses, including the conditions we consider in determining the unallocated allowance and our portfolio credit quality, underwriting standards, and risk grading

Our assessment of economic conditions and trends and credit cycles and their impact on our business

The seasonal nature of our business

The impact of changes in interest rates and our strategy to manage our interest rate risk profile and the possible effect of increases in residential mortgage interest rates on new originations and refinancing of existing residential mortgage loans.

Loan portfolio composition and risk grade trends, expected charge-offs, portfolio credit quality, our strategy regarding troubled debt restructurings ("TDRs"), delinquency rates and our underwriting standards

Our deposit base including renewal of time deposits

The impact on our net interest income and net interest margin from the current low-interest rate environment

Expectations regarding an increase or decrease in unrecognized tax benefits

Our pension and retirement plan costs

Our liquidity position

Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or changes in accounting principles

Expected rates of return, maturities, loss exposure, growth rates, yields and projected results

The possible impact of the California drought and related governmental responses on economic conditions, especially in the agricultural sector

Maintenance of insurance coverage appropriate for our operations

Threats to the banking sector and our business due to cybersecurity issues and attacks and regulatory expectations related to cybersecurity

Descriptions of assumptions underlying or relating to any of the foregoing

Readers of this document should not rely on any forward-looking statements, which reflect only our management's belief as of the date of this report. There are numerous risks and uncertainties that could and will cause actual results to differ materially from those discussed in our forward-looking statements. Many of these factors are beyond our ability to control or predict and could have a material adverse effect on our financial condition and results of operations or prospects. Such risks and uncertainties include, but are not limited to those listed in Item 1A "Risk Factors" of Part II of this Form 10-Q, Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I of this Form 10-Q and "Risk Factors" and "Supervision and Regulation" in our 2014 Annual Report on Form 10-K, and in our other reports to the SEC.



## INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire report and any other reports to the Securities and Exchange Commission ("SEC"), together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2014.

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

Significant results and developments during the third quarter and year-to-date 2015 included:

Net income of \$5.1 million for the nine months ended September 30, 2015, up 18.6% from \$4.3 million earned for the same period last year.

Net income available to common shareholders of \$5.0 million for the nine months ended September 30, 2015, up 19.0% from \$4.2 million for the same period last year.

Diluted income per share for the nine months ended September 30, 2015 was \$0.49, up 19.5% from diluted income per share of \$0.41 in the same period last year.

Net interest income increased in the nine months ended September 30, 2015 by \$1.5 million, or 6.8%, to \$23.5 million from \$22.0 million in the same period last year. The increase in net interest income was primarily due to an increase in interest income on loans and other interest-earning assets and a decrease in interest expense, which was partially offset by a decrease in interest income on investment securities. The increase in interest income on loans was primarily due to an increase in average loans, partially offset by a decrease in interest yield. The increase in interest income on other interest-earning assets was primarily due to a special dividend paid by the FHLB in the current year. The decrease in interest expense was primarily due to a decrease in interest yield, partially offset by an increase in average balance. The decrease in interest income on investment securities was due to a decrease in average balance and interest yield.

Net interest margin increased from 3.33% for the nine months ended September 30, 2014 to 3.34% for the same period ended September 30, 2015.

Provision for loan losses of \$0.7 million for the nine months ended September 30, 2015, compared to a provision for loan losses of \$1.6 million for the same period in 2014.

Total assets at September 30, 2015 were \$1 billion, an increase of \$79.8 million, or 8.3%, compared to total assets at December 31, 2014.

Total net loans at September 30, 2015 (including loans held-for-sale) increased \$54.3 million, or 10.1%, to \$592.7 million compared to December 31, 2014.

Total investment securities at September 30, 2015 decreased \$16.6 million, or 11.0%, to \$134.6 million compared to December 31, 2014.

Total deposits of \$931.3 million at September 30, 2015, represented an increase of \$74.3 million, or 8.7%, compared to December 31, 2014.

Net income of \$1.8 million for the three months ended September 30, 2015, up 12.5% from \$1.6 million for the same period last year.

Net income available to common shareholders of \$1.8 million for the three months ended September 30, 2015, up 20.0% from \$1.5 million for the same period last year.

Diluted income per share for the three months ended September 30, 2015 was \$0.17, up 13.3% from diluted income per share of \$0.15 in the same period last year.

## SUMMARY

The Company recorded net income of \$5,106,000 for the nine months ended September 30, 2015, representing an increase of \$833,000 or 19.5% from net income of \$4,273,000 for the same period in 2014. The Company recorded net income of \$1,819,000 for the three months ended September 30, 2015, representing an increase of \$249,000 or 15.9% from net income of \$1,570,000 for the same period in 2014.

The following tables present a summary of the results for the three and nine months ended September 30, 2015 and 2014, and a summary of financial condition at September 30, 2015 and December 31, 2014.

	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
(in thousands except for per share amounts)				
For the Period:				
Net Income	\$ 1,819	\$ 1,570	\$ 5,106	\$ 4,273
Net Income Available to Common Shareholders	\$ 1,787	\$ 1,537	\$ 5,010	\$ 4,176
Basic Earnings Per Common Share	\$ 0.18	\$ 0.15	\$ 0.49	\$ 0.41
Diluted Earnings Per Common Share	\$ 0.17	\$ 0.15	\$ 0.49	\$ 0.41

	September 30, 2015	December 31, 2014
(in thousands except for ratios)		
At Period End:		
Total Assets	\$1,037,676	\$957,884
Total Loans, Net (including loans held-for-sale)	\$592,744	\$538,470
Total Investment Securities	\$134,582	\$151,226
Total Deposits	\$931,348	\$857,052
Loan-To-Deposit Ratio	63.6	% 62.8 %

## FIRST NORTHERN COMMUNITY BANCORP

## Distribution of Average Statements of Condition and Analysis of Net Interest Income

(in thousands, except percentage amounts)

	Three months ended September 30, 2015			Three months ended September 30, 2014		
	Average Balance	Interest	Yield/ Rate (4)	Average Balance	Interest	Yield/ Rate (4)
Assets						
Interest-earning assets:						
Loans (1)	\$578,417	\$7,480	5.13 %	\$517,208	\$6,717	5.15 %
Certificate of deposits	11,937	21	0.70 %	11,373	21	0.73 %
Interest bearing due from banks	215,240	124	0.23 %	194,567	111	0.23 %
Investment securities, taxable	137,341	631	1.82 %	148,996	741	1.97 %
Investment securities, non-taxable (2)	8,691	68	3.10 %	8,919	85	3.78 %
Other interest earning assets	3,934	97	9.78 %	3,934	77	7.77 %
Total average interest-earning assets	955,560	8,421	3.50 %	884,997	7,752	3.48 %
Non-interest-earning assets:						