FIRST NORTHERN COMMUNITY BANCORP
Form 10-Q
November 09, 2009
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2009

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 x 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 r No r

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).

| Large accelerated filer ¨ | Accelerated filer x | Non-accelerated filer ¨ | Smaller reporting company x |
|---|---|---|---|

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

Yes ¨ No x

The number of shares of Common Stock outstanding as of November 6, 2009 was 9,009,462.

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FIRST NORTHERN COMMUNITY BANCORP

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PART I – FINANCIAL INFORMATION

FIRST NORTHERN COMMUNITY BANCORP

ITEM I – FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS

| (in thousands, except share amounts) | September 30, 2009 (unaudited) | December 31, 2008 |
|---|---|---|
| Assets | | |
| | | |
| Cash and due from banks | $112,922 | $25,150 |
| Federal funds sold | — | 40,860 |
| Investment securities – available-for-sale | 87,218 | 42,106 |
| Loans, net of allowance for loan losses of $14,179 at September 30, 2009 and $14,435 at December 31, 2008 | 482,390 | 516,968 |
| Loans held-for-sale | 3,219 | 2,192 |
| Stock in Federal Home Loan Bank and other equity securities, at cost | 2,506 | 2,311 |
| Premises and equipment, net | 7,385 | 7,620 |
| Other Real Estate Owned | 4,748 | 4,368 |
| Accrued interest receivable and other assets | 29,568 | 29,227 |
| | | |
| Total Assets | $729,956 | $670,802 |
| | | |
| Liabilities and Stockholders' Equity | | |
| | | |
| Liabilities: | | |
| | | |
| Demand deposits | $168,287 | $181,600 |
| Interest-bearing transaction deposits | 124,228 | 123,614 |
| Savings and MMDA's | 180,865 | 155,656 |
| Time, under $100,000 | 57,938 | 64,252 |
| Time, $100,000 and over | 98,874 | 59,596 |
| Total deposits | 630,192 | 584,718 |
| | | |
| FHLB Advances and other borrowings | 11,876 | 18,259 |
| Accrued interest payable and other liabilities | 6,425 | 5,796 |
| | | |
| Total liabilities | 648,493 | 608,773 |
| | | |
| Stockholders' Equity: | | |
| Preferred stock, par value $0.01 per share; $1,000 per share liquidation preference, 18,500 shares authorized; 17,390 shares issued and outstanding at September 30, 2009 and none at December 31, 2008 | 16,791 | — |

| | | |
|---|---|---|
| Common stock, no par value; 16,000,000 shares authorized; | | |
| 8,973,645 shares issued and outstanding at September 30, 2009 and | | |
| 8,608,802 shares issued and outstanding at December 31, 2008 | 62,185 | 58,983 |
| Additional paid in capital | 977 | 977 |
| Retained earnings | 789 | 2,026 |
| Accumulated other comprehensive income | 721 | 43 |
| Total stockholders' equity | 81,463 | 62,029 |
| | | |
| Total Liabilities and Stockholders' Equity | $729,956 | $670,802 |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

| (in thousands, except per share amounts) | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|---|---|
| Interest and Dividend Income: | | | | |
| Loans | $ 7,545 | $ 9,062 | $ 23,315 | $ 26,842 |
| Federal funds sold | 19 | 70 | 58 | 487 |
| Due from banks interest bearing accounts | 28 | 109 | 88 | 521 |
| Investment securities | | | | |
| Taxable | 353 | 282 | 820 | 1,122 |
| Non-taxable | 247 | 300 | 765 | 986 |
| Other earning assets | 4 | 33 | 10 | 99 |
| Total interest and dividend income | 8,196 | 9,856 | 25,056 | 30,057 |
| Interest Expense: | | | | |
| Deposits | 1,155 | 1,282 | 3,288 | 4,635 |
| Other borrowings | 109 | 247 | 390 | 394 |
| Total interest expense | 1,264 | 1,529 | 3,678 | 5,029 |
| Net interest income | 6,932 | 8,327 | 21,378 | 25,028 |
| Provision for loan losses | 1,661 | 3,638 | 3,928 | 10,060 |
| Net interest income after provision for loan losses | 5,271 | 4,689 | 17,450 | 14,968 |
| Other operating income: | | | | |
| Service charges on deposit accounts | 909 | 952 | 2,653 | 2,805 |
| Gains on other real estate owned | — | 78 | 4 | 78 |
| Gains on sales of loans held-for-sale | 146 | 29 | 720 | 203 |
| Investment and brokerage services income | 334 | 251 | 657 | 635 |
| Mortgage brokerage income | 22 | 3 | 65 | 16 |
| Loan servicing income | 350 | 30 | 709 | 189 |
| Fiduciary activities income | 60 | 72 | 216 | 245 |
| ATM fees | 60 | 61 | 182 | 199 |
| Signature based transaction fees | 175 | 153 | 478 | 444 |
| Gains on sales of available-for-sale securities | 4 | 29 | 268 | 524 |
| Other income | 192 | 188 | 507 | 583 |
| Total other operating income | 2,252 | 1,846 | 6,459 | 5,921 |
| Other operating expenses: | | | | |
| Salaries and employee benefits | 3,817 | 3,650 | 11,471 | 11,716 |
| Occupancy and equipment | 950 | 913 | 2,888 | 2,777 |
| Data processing | 458 | 436 | 1,347 | 1,254 |
| Stationery and supplies | 74 | 83 | 293 | 370 |
| Advertising | 154 | 137 | 467 | 503 |
| Directors' fees | 55 | 53 | 158 | 158 |
| Other real estate owned expense and write-downs | 135 | 843 | 1,464 | 1,530 |

| | | | | |
|---|---|---|---|---|
| Other expense | 1,518 | 1,021 | 4,859 | 3,979 |
| Total other operating expenses | 7,161 | 7,136 | 22,947 | 22,287 |
| Income (loss) before benefit for income taxes | 362 | (601) | 962 | (1,398) |
| Benefit for income taxes | (169) | (1,573) | (598) | (1,566) |
| | | | | |
| Net income | $ 531 | $ 972 | $ 1,560 | $ 168 |
| | | | | |
| Preferred stock dividends and accretion | $ (249) | — | $ (544) | — |
| Net income available to common shareholders | $ 282 | $ 972 | $ 1,016 | $ 168 |
| | | | | |
| Basic income per share | $ 0.03 | $ 0.11 | $ 0.11 | $ 0.02 |
| Diluted income per share | $ 0.03 | $ 0.11 | $ 0.11 | $ 0.02 |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

(in thousands, except share amounts)

| | Preferred Stock | Common Stock Shares | Common Stock Amounts | Comprehensive Income | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2008 | $— | 8,608,802 | $58,983 | | $977 | $2,026 | $ 43 | $62,029 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | $ 1,560 | | 1,560 | | 1,560 |
| Other comprehensive income, net of tax: | | | | | | | | |
| Unrealized holding losses on securities arising during the current period, net of tax effect of $560 | | | | 839 | | | | |
| Reclassification adjustment due to gains realized on sales of securities, net of tax effect of $107 | | | | (161) | | | | |
| Total other comprehensive income, net of tax effect of $453 | | | | 678 | | | 678 | 678 |
| | | | | | | | | |
| Comprehensive income | | | | $ 2,238 | | | | |
| | | | | | | | | |
| Issuance of preferred stock | 16,726 | | | | | | | 16,726 |
| Issuance of common stock warrants | | | 664 | | | | | 664 |
| 4% stock dividend | | 346,011 | 2,249 | | | (2,249) | | — |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Dividend on preferred stock | | | | | (478) | | (478) |
| Discount accretion on preferred stock | 65 | | | | (65) | | — |
| Cash in lieu of fractional shares | | | | | (5) | | (5) |
| Stock-based compensation and related tax benefits | | | 289 | | | | 289 |
| Common shares issued, stock options exercised, net of swapped shares | | 18,832 | | | | | |
| Balance at September 30, 2009 | $16,791 | 8,973,645 | $62,185 | $977 | $789 | $721 | $81,463 |

See notes to unaudited condensed consolidated financial statements.

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FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | (in thousands) | |
|---|---|---|
| | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
| Cash Flows From Operating Activities | | |
| Net Income | $ 1,560 | $ 168 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 716 | 791 |
| Provision for loan losses | 3,928 | 10,060 |
| Stock plan accruals | 279 | 373 |
| Tax benefit for stock options | 10 | 20 |
| Gains on sales of available-for-sale securities | (268) | (524) |
| Gains on sales of other real estate owned | (4) | (78) |
| Write-downs on other real estate owned | 1,158 | 1,454 |
| Gains on sales of loans held-for-sale | (720) | (203) |
| Proceeds from sales of loans held-for-sale | 86,604 | 27,386 |
| Originations of loans held-for-sale | (86,911) | (27,455) |
| Changes in assets and liabilities: | | |
| Decrease in accrued interest receivable and other assets | (783) | (4,175) |
| Increase (decrease) in accrued interest payable and other liabilities | 151 | (1,557) |
| Net cash provided by operating activities | 5,720 | 6,260 |
| | | |
| Cash Flows From Investing Activities | | |
| Net (increase) decrease in investment securities | (43,714) | 32,808 |
| Net decrease (increase) in loans | 28,437 | (46,018) |
| Net increase in other interest earning assets | (195) | (91) |
| Net decrease in OREO | 679 | — |
| Purchases of premises and equipment, net | (481) | (1,954) |
| Net cash used in investing activities | (15,274) | (15,255) |
| | | |
| Cash Flows From Financing Activities | | |
| Net increase (decrease) in deposits | 45,474 | (63,449) |
| Proceeds from issuance of preferred stock | 16,726 | — |
| Proceeds from issuance of common stock warrants | 664 | — |
| Net (decrease) increase in FHLB advances and other borrowings | (6,383) | 14,745 |
| Cash dividends paid | (5) | (10) |
| Tax benefit for stock options | (10) | (20) |
| Repurchase of stock | — | (1,359) |
| Net cash provided by (used) in financing activities | 56,466 | (50,093) |
| | | |
| Net Increase (Decrease) in Cash and Cash Equivalents | 46,912 | (59,088) |

| | | |
|---|---|---|
| Cash and Cash Equivalents, beginning of period | 66,010 | 99,030 |
| Cash and Cash Equivalents, end of period | $112,922 | $39,942 |
| | | |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | $3,692 | $5,260 |
| Income Taxes | $481 | $342 |
| | | |
| Supplemental disclosures of non-cash investing and financing activities: | | |
| Preferred stock dividend payable and accretion | $543 | — |
| Transfer of loans held-for-investment to other real estate owned | $2,213 | $6,343 |
| Stock dividend distributed | $2,249 | $8,642 |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2009 and 2008 and December 31, 2008

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 to stockholders and Form 10-K for the year ended December 31, 2008 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 December 2007, the Financial Accounting Standards Board (the "FASB") updated the account standards for Business Combinations, which requires most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at "full fair value" at the acquisition date. The standard applies to all business combinations, including combinations among mutual entities and combinations by contract alone. Under the standard, all business combinations will be accounted for by applying the acquisition method. The standard is effective for periods beginning on or after December 15, 2008. Earlier application is prohibited. The standard will be applied to business combinations occurring after the effective date. The Company currently does not have any business combination contemplated that are expected to be closed after the effective date; therefore, the adoption of the standard did not have an impact on the consolidated financial statements or results of operations of the Company.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110 ("SAB No. 110"), Certain Assumptions Used in Valuation Methods, which extends the use of the "simplified" method, under certain circumstances, in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123R. Prior to SAB No. 110, SAB No. 107 stated that the simplified method was only available for grants made up to December 31, 2007. The Company currently plans to continue to use the simplified method in developing an estimate of expected term of stock options.

In March 2008, the FASB updated the accounting standards for Disclosures about Derivative Instruments and Hedging Activities). The standard requires enhanced disclosures about an entity's derivative and hedging activities and thereby improving the transparency of financial reporting. It is intended to enhance the current disclosure framework by requiring that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. This disclosure better conveys the purpose of derivative use in terms of the risks that the entity is intending to manage. The standard was effective for the Company on January 1, 2009 and will result in

additional disclosures if the Company enters into any material derivative or hedging activities.

In May 2008, the FASB updated the accounting standards on The Hierarchy of Generally Accepted Accounting Principals). The standard is intended to improve financial statements that are presented in conformity with U.S. generally accepted accounting principals for non-governmental entities. The standard is effective 60 days following the SEC's approval of the PCAOB amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principals. Management does not believe the adoption of the standard will have a material impact on the Company's financial statements.

In June, 2008, the FASB issued guidance on Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. Unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and must be included in the earnings per share computation. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period earnings per share data presented must be adjusted retrospectively. Early application is not permitted. The adoption of this guidance had no material effect on the Company's financial position, results of operations or cash flows.

In April 2009, the FASB issued guidance intended to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities.

This guidance is as follows:

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

This guidance relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. There was no impact on the consolidated financial statements of the Company as a result of the adoption of this guidance during the second quarter of 2009.

Interim Disclosures about Fair Value of Financial Instruments

This guidance relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this guidance, fair values for these assets and liabilities were only disclosed once a year. The guidance now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. This guidance is effective for interim reporting periods ending after June 15, 2009. The Company adopted this guidance for the quarter ended June 30, 2009.

Recognition and Presentation of Other-Than-Temporary Impairments

This guidance on other-than-temporary impairments is intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and non-credit components of impaired debt securities that are not expected to be sold. The measure of impairment in comprehensive income remains fair value. This guidance also requires increased and timelier disclosures sought by investors regarding expected cash flows, credit losses, and an aging of securities with unrealized losses. The Company adopted this guidance during the second quarter of 2009, but the adoption did not have any impact on the consolidated financial statements since the Company did not hold any other-than-temporarily impaired debt securities.

In May 2009, the FASB updated the accounting standards on the recognition of Subsequent Events, which establishes general standards of accounting for, and requires disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company adopted the provisions of the standard for the quarter ended June 30, 2009. The adoption of these provisions did not have a material effect on the Company's financial statements.

In June 2009, the FASB established the FASB Accounting Standards CodificationTM ("Codification") as the single source of authoritative accounting principles recognized by the FASB in the preparation of financial statements in conformity with GAAP. The Codification supersedes existing non-grandfathered, non-SEC accounting, and reporting standards. The Codification did not change GAAP but rather organized it into a hierarchy where all guidance within the Codification carries an equal level of authority. The Codification became effective on July 1, 2009. The Codification did not have a material effect on the Company's consolidated results of operations and financial condition.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations and cash flows.

Reclassifications

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

2. ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at levels considered adequate by management to provide for loan losses that can be reasonably anticipated. The allowance is based on management's assessment of various factors affecting the loan portfolio, including problem loans, economic conditions and loan loss experience, and an overall evaluation of the quality of the underlying collateral. See discussion on page [INSERT PAGE NUMBER] "Asset Quality" regarding impaired/problem loans.

Changes in the allowance for loan losses during the nine-month periods ended September 30, 2009 and 2008 and for the year ended December 31, 2008 were as follows:

(in thousands)

| | Nine months ended September 30, | | Year ended December 31, |
|---|---|---|---|
| | 2009 | 2008 | 2008 |
| Balance, beginning of period | $ 14,435 | $ 10,876 | $ 10,876 |
| Provision for loan losses | 3,928 | 10,060 | 16,164 |
| Loan charge-offs | (5,079) | (8,009) | (13,324) |
| Loan recoveries | 895 | 511 | 719 |
| Balance, end of period | $ 14,179 | $ 13,438 | $ 14,435 |

## 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, 2009 for cash proceeds equal to the fair value of the loans.

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

At September 30, 2009, the Company had $3,219,000 of mortgage loans held-for-sale. At September 30, 2009 and December 31, 2008, the Company serviced real estate mortgage loans for others of $175,768,000 and $122,734,000, respectively.

The following table summarizes the Company’s mortgage servicing rights assets as of September 30, 2009 and December 31, 2008.

| | (in thousands) | | | |
|---|---|---|---|---|
| | December 31, 2008 | Additions | Reductions | September 30, 2009 |
| Mortgage servicing rights | $ 978 | $ 725 | $ 196 | $ 1,507 |
| Valuation allowance | (85) | (106) | — | (191) |
| Mortgage servicing rights, net of valuation allowance | $ 893 | $ 619 | $ 196 | $ 1,316 |

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4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 22, 2009, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2009 to shareholders of record as of February 27, 2009. 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 by the weighted average number of common shares outstanding for the period. Diluted EPS includes all common stock equivalents ("in-the-money" stock options, unvested restricted stock, stock units, warrants and rights, convertible bonds and preferred stock), which reflects the potential dilution of securities that could share in the earnings of an entity.

The following table presents a reconciliation of basic and diluted EPS for the three-month and nine-month periods ended September 30, 2009 and 2008

| | (in thousands, except share and earnings) | | | |
|---|---|---|---|---|
| | Three months ended September 30, | | Nine months ended September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Basic earnings per share: | | | | |
| Net income | $531 | $972 | $1,560 | $168 |
| Preferred stock dividend and accretion | $(249) | — | $(544) | — |
| Net income available to common shareholders | $282 | $972 | $1,016 | $168 |
| | | | | |
| Weighted average common shares outstanding | 8,973,645 | 8,924,720 | 8,968,860 | 8,964,050 |
| Basic EPS | $0.03 | $0.11 | $0.11 | $0.02 |
| | | | | |
| Diluted earnings per share: | | | | |
| Net income | $531 | 972 | $1,560 | $168 |
| Preferred stock dividend and accretion | $(249) | — | $(544) | — |
| Net income available to common shareholders | $282 | $972 | $1,016 | $168 |
| | | | | |
| Weighted average common shares outstanding | 8,973,645 | 8,924,720 | 8,968,860 | 8,964,050 |
| | | | | |
| Effect of dilutive options | 5,605 | 83,292 | 25,470 | 146,837 |
| | | | | |
| Adjusted weighted average common shares outstanding | 8,979,250 | 9,008,012 | 8,994,330 | 9,110,887 |
| Diluted EPS | $0.03 | $0.11 | $0.11 | $0.02 |

Options not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 424,954 shares and 219,839 shares for the three months ended September 30, 2009 and 2008 respectively. In addition, 352,977 warrants issued to the U.S. Treasury were not used in the computation of diluted earnings per share because they would have had an anti-dilutive effect.

Options not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 424,954 shares and 123,667 shares for the nine months ended September 30, 2009 and 2008

respectively. In addition, 352,977 warrants issued to the U.S. Treasury were not used in the computation of diluted earnings per share because they would have had an anti-dilutive effect.



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5. STOCK PLANS

The following table presents the activity related to stock options for the three months ended September 30, 2009.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 520,336 | $11.19 | | |
| Granted | — | — | | |
| Cancelled / Forfeited | — | — | | |
| Exercised | — | — | — | |
| Options outstanding at End of Period | 520,336 | $11.19 | $104,168 | 4.29 |
| Exercisable (vested) at End of Period | 466,870 | $10.50 | $92,168 | 3.93 |

The following table presents the activity related to stock options for the nine months ended September 30, 2009.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 555,591 | $10.71 | | |
| Granted | 8,000 | $4.50 | | |
| Cancelled / Forfeited | (1,840) | $3.65 | | |
| Exercised | (41,415) | $3.81 | $101,246 | |
| Options outstanding at End of Period | 520,336 | $11.19 | $104,168 | 4.29 |
| Exercisable (vested) at End of Period | 466,870 | $10.50 | $92,168 | 3.93 |

The weighted average fair value of options granted during the nine-month period ended September 30, 2009 was $1.75 per share.

As of September 30, 2009, there was $152,000 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 1.38 years.

There was $133,000 of recognized compensation cost related to non-vested stock options for the nine months ended September 30, 2009.

A summary of the weighted average assumptions used in valuing stock options during the three months and nine months ended September 30, 2009 is presented below:

| | Three Months Ended September 30, 2009* | Nine Months Ended September 30, 2009 |
|---|---|---|
| Risk Free Interest Rate | — | 2.00% |
| Expected Dividend Yield | — | 0.00% |
| Expected Life in Years | — | 5 |
| Expected Price Volatility | — | 41.35% |

* There were no stock options or restricted stock granted during the three-month period ended September 30, 2009.

The following table presents the activity related to restricted stock for the three months ended September 30, 2009.

| | Number of Shares | Weighted Average Grant-Date Fair Value | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 35,817 | $13.20 | | |
| Granted | — | — | | |
| Cancelled / Forfeited | — | — | | |
| Exercised/Released/Vested | — | — | — | |
| Options outstanding at End of Period | 35,817 | $13.20 | $214,902 | 8.40 |

The following table presents the activity related to restricted stock for the nine months ended September 30, 2009.

| | Number of Shares | Weighted Average Grant-Date Fair Value | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 31,071 | $16.03 | | |
| Granted | 9,300 | $4.50 | | |
| Cancelled / Forfeited | — | — | | |
| Exercised/Released/Vested | (4,554) | $14.79 | $22,551 | |
| Options outstanding at End of Period | 35,817 | $13.20 | $214,902 | 8.40 |

The weighted average fair value of options granted during the nine-month period ended September 30, 2009 was $4.50 per share.

As of September 30, 2009, there was $247,000 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 2.30 years.

There was $93,000 of recognized compensation cost related to non-vested stock options for the nine months ended September 30, 2009.

The Company has an Employee Stock Purchase Plan ("ESPP"). Under the plan, the Company is authorized to issue to eligible employees shares of common stock. There are 292,136 (adjusted for the 2009 stock dividend) shares authorized under the ESPP. The ESPP will terminate February 27, 2017. The ESPP is implemented by participation periods of not more than twenty-seven months each. The Board of Directors determines the commencement date and duration of each participation period. The Board of Directors approved the current participation period of November 24, 2008 to November 23, 2009. An eligible employee is one who has been continually employed for at least ninety (90) days prior to commencement of a participation period. Under the terms of the ESPP, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company's common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair market value on the last trading day before the date of participation or the fair market value on the last trading day during the participation period.

As of September 30, 2009, there was $18,000 of unrecognized compensation cost related to ESPP grants. This cost is expected to be recognized over a weighted average period of approximately 0.25 years.

There was $53,000 of recognized compensation cost related to ESPP grants for the nine-month period ended September 30, 2009.

The weighted average fair value at grant date during the nine-month period ended September 30, 2009 was $2.36.

A summary of the weighted average assumptions used in valuing ESPP grants during the three months and nine months ended September 30, 2009 is presented below:

| | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2009 |
|---|---|---|
| Risk Free Interest Rate | 0.95% | 0.95% |
| Expected Dividend Yield | 0.00% | 0.00% |
| Expected Life in Years | 1.00 | 1.00 |
| Expected Price Volatility | 48.13% | 48.13% |

6. EXECUTIVE SALARY CONTINUATION PLAN

The Company has an unfunded non-contributory defined benefit pension plan provided in two forms to a select group of highly compensated employees.

Four executives have Salary Continuation Plans providing retirement benefits between $50,000 and $100,000 based on responsibilities and tenure at the Company. The retirement benefits are paid for 10 years following retirement at age 65. Reduced retirement benefits are available after age 55 and 10 years of service.

The Supplemental Executive Retirement Plan is intended to provide a fixed annual benefit for 10 years plus 6 months for each full year of service over 10 years (limited to 180 months total) subsequent to retirement at age 65. Reduced benefits are payable as early as age 55 if the participant has at least 10 years of service. Two employees currently have Supplemental Executive Retirement Plan agreements. The agreements provide a target benefit of 2% (2.5% for the CEO) times years of service multiplied by final average compensation. Final average compensation is defined as three-year average salary plus seven-year average bonus. The target benefit is reduced by benefits from social security and the Company's profit sharing plan. The maximum target benefit is 50% of final average compensation.

| | Three months ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Components of Net Periodic Benefit Cost | | |
| Service Cost | $3,990 | $33,232 |
| Interest Cost | 26,418 | 29,684 |
| Amortization of Plan Gain | (8,179) | — |
| Amortization of prior service cost | 21,821 | 21,821 |
| Net periodic benefit cost | $44,050 | $84,737 |

The Company estimates that the annual net periodic benefit cost will be $176,196 for the year ended December 31, 2009 This compares to an annual net periodic benefit cost of $336,855 for the year ended December 31, 2008.

Estimated Contributions for Fiscal 2009

For unfunded plans, contributions to the Executive Salary Continuation Plan are the benefit payments made to participants. At December 31, 2008 the Company expected to make benefit payments of $54,144 in connection with the Executive Salary Continuation Plan during fiscal 2009.

7. DIRECTORS' RETIREMENT PLAN

The Company has an unfunded non-contributory defined benefit pension plan ("Directors' Retirement Plan"). The Directors' Retirement Plan provides a retirement benefit equal to $1,000 per year of service as a director up to a maximum benefit of $15,000. The retirement benefit is payable monthly for 10 years following retirement at age 65. Reduced retirement benefits are available after age 55 and 10 years of service.

| | Three months ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Components of Net Periodic Benefit Cost | | |
| Service Cost | $11,088 | $14,424 |
| Interest Cost | 7,920 | 7,731 |
| Net periodic benefit cost | $19,008 | $22,155 |

The Company estimates that the annual net periodic benefit cost will be $76,034 for the year ended December 31, 2009. This compares to annual net periodic benefit costs of $88,622 for the year ended December 31, 2008.

Estimated Contributions for Fiscal 2009

For unfunded plans, contributions to the Directors' Retirement Plan are the benefit payments made to participants. At December 31, 2008 the Company expected to make cash contributions of $15,000 to the Directors' Retirement Plan during fiscal 2009.

## 8. 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, trading securities and derivatives 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.

### Fair Value Hierarchy

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

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

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

### Investment Securities Available-for-Sale

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

### Loans Held-for-Sale

Loans held-for-sale are carried at the lower of cost or market 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.

### 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. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

At September 30, 2009, substantially all of the total impaired loans 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 the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as non-recurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as non-recurring Level 3.

Other Real Estate Owned

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

Loan Servicing Rights

Loan servicing rights are subject to impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used in the completion of impairment testing. 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, 2009 by SFAS No. 157 valuation hierarchy.

| | | (in thousands) | | |
|---|---|---|---|---|
| September 30, 2009 | Total | Level 1 | Level 2 | Level 3 |
| Investment securities available-for-sale | $87,218 | $255 | $86,963 | $— |
| | | | | |
| Total investments at fair value | $87,218 | $255 | $86,963 | $— |

Assets Recorded at Fair Value on a Non-recurring Basis

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

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of September 30, 2009.

| | | (in thousands) | | |
|---|---|---|---|---|
| September 30, 2009 | Total | Level 1 | Level 2 | Level 3 |
| Impaired loans | $4,687 | $— | $— | $4,687 |

| | | | | |
|---|---|---|---|---|
| Other real estate owned | 4,748 | — | — | 4,748 |
| Loan servicing rights | 1,316 | — | — | 1,316 |
| Total assets at fair value | $10,751 | $— | $— | $10,751 |

9. PREFERRED STOCK AND COMMON STOCK WARRANTS

On March 13, 2009, we issued to the U.S. Treasury 17,390 shares of our Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value $0.01 per share, having a liquidation preference per share equal to $1,000. The Series A Preferred Stock pays cumulative dividends at a rate of 5% per year for the first five years and thereafter at a rate of 9% per year. At any time, we may, at our option, subject to any necessary bank regulatory approval, redeem the Series A Preferred Stock at a price equal to its liquidation preference plus accrued and unpaid dividends. The Series A Preferred Stock is generally non-voting. We are not permitted to increase dividends on our common shares above the amount of the last quarterly cash dividend per share declared prior to March 13, 2009 without the U.S. Treasury's approval (but this does not affect our ability to declare and pay stock dividends) unless all of the Series A Preferred Shares have been redeemed or transferred by the U.S. Treasury to unaffiliated third parties. The consent of the U.S. Treasury generally is required for us to make any stock repurchase (other than in connection with the administration of any employee benefit plan in the ordinary course of business and consistent with past practice), unless all of the Series A Preferred Shares have been redeemed or transferred by the U.S. Treasury to unaffiliated third parties. Further, our common shares may not be repurchased if we are in arrears on the payment of Series A Preferred Shares dividends. The U.S. Treasury, as part of the preferred stock issuance, received a warrant to purchase 352,977 shares of our common stock at an initial exercise price of $7.39. The proceeds from the U.S. Treasury were allocated based on the relative fair value of the warrants as compared with the fair value of the preferred stock. The fair value of the warrants was determined using a valuation model which incorporates assumptions including our common stock price, dividend yield, stock price volatility and the risk-free interest rate. The fair value of the preferred stock is determined based on assumptions regarding the discount rate (market rate) on the preferred stock which was estimated to be approximately 12% at the date of issuance. The discount on the preferred stock will be accreted to par value using a constant effective yield of approximately 5.9% over a ten-year term, which is the expected life of the preferred stock. Both the preferred stock and the warrant are accounted for as components of Tier 1 Capital.

10. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash and short-term instruments are a reasonable estimate of fair value.

Investment Securities

Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

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 carrying amount of accrued interest receivable approximates its fair value.

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Commitments to Extend Credit and Standby Letters of Credit

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligation with the counterparties at the reporting date.

Deposit Liabilities

The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. The carrying amount of accrued interest payable approximates its fair value.

FHLB Advances and Other Borrowings

The fair values of borrowed funds were estimated by discounting future cash flows related to these financial instruments using current market rates for financial instruments with similar characteristics.

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 period ended September 30, 2009 are approximately as follows:

| | September 30, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| (in thousands) | Carrying amount | Fair value | Carrying amount | Fair value |
| Financial assets: | | | | |
| Cash and federal funds sold | $112,922 | $112,922 | $66,010 | $66,010 |
| Investment securities | 87,218 | 87,218 | 42,106 | 42,106 |
| Other equity securities | 2,506 | 2,506 | 2,311 | 2,311 |
| Loans: | | | | |
| Net loans | 482,390 | 483,244 | 516,968 | 516,949 |
| Loans held-for-sale | 3,219 | 3,303 | 2,192 | 2,192 |
| Financial liabilities: | | | | |
| Deposits | 630,192 | 612,427 | 584,718 | 547,419 |
| FHLB advances and other borrowings | 11,876 | 12,331 | 18,259 | 19,025 |

| | September 30, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| (in thousands) | Contract amount | Fair value | Contract amount | Fair value |
| Unrecognized financial instruments: | | | | |
| Commitments to extend credit | $172,443 | $1,293 | $198,615 | $1,490 |
| Standby letters of credit | 3,747 | 37 | 5,715 | 57 |

11. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated market values of investments in debt and other securities at September 30, 2009 are summarized as follows:

| (in thousands) | Amortized cost | Unrealized gains | Unrealized losses | Estimated market value |
|---|---|---|---|---|
| Investment securities available-for-sale: | | | | |
| U.S. Treasury securities | $255 | $— | $— | $255 |
| Securities of U.S. government agencies and corporations | — | — | — | — |
| Obligations of states and political subdivisions | 23,803 | 1026 | (69) | 24,760 |
| Mortgage-backed securities | 61,758 | 543 | (98) | 62,203 |
| | | | | |
| Total debt securities | $85,816 | $1,569 | $(167) | $87,218 |

The amortized cost, unrealized gains and losses and estimated market values of investments in debt and other securities at December 31, 2008 are summarized as follows:

| (in thousands) | Amortized cost | Unrealized gains | Unrealized losses | Estimated market value |
|---|---|---|---|---|
| Investment securities available-for-sale: | | | | |
| U.S. Treasury securities | $ 249 | $ 25 | $— | $ 274 |
| Securities of U.S. government agencies and corporations | 2,018 | 21 | — | 2,039 |
| Obligations of states and political subdivisions | 26,345 | 244 | (358) | 26,231 |
| Mortgage-backed securities | 13,223 | 369 | (30) | 13,562 |
| | | | | |
| Total debt securities | $ 41,835 | $ 659 | $(388) | $ 42,106 |

Gross realized gains from sales of available-for-sale securities were $268 for the nine months ended September 30, 2009 and $666 for the year ended December 31, 2008. Gross realized losses from sales of available-for-sale securities were $0 for the nine months ended September 30, 2009 and $97 for the year ended December 31, 2008.

The amortized cost and estimated market value of debt and other securities at September 30, 2009, by contractual maturity, are shown in the following table:

| (in thousands) | Amortized cost | Estimated market value |
|---|---|---|
| Due in one year or less | $1,451 | $1,460 |
| Due after one year through five years | 62,493 | 62,984 |
| Due after five years through ten years | 3,879 | 3,952 |
| Due after ten years | 17,993 | 18,822 |
| | | |
| | $85,816 | $87,218 |

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 totaling $60,602. 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, 2009, follows:

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| (in thousands) | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| Obligations of states and political subdivisions | 989 | (21) | 1,014 | (49) | 2,003 | (70) |
| Mortgage-backed securities | 12,865 | (97) | — | — | 12,865 | (97) |
| Total | $13,854 | $(118) | $1,014 | $(49) | $14,868 | $(167) |

No decline in value was considered “other-than-temporary” during 2009. Thirteen securities that had a fair market value of $13,854 and a total unrealized loss of $118 have been in an unrealized loss position for less than twelve months as of September 30, 2009. In addition, three securities with a fair market value of $1,014 and a total unrealized loss of $49 have been in an unrealized loss position for more than twelve months as of September 30, 2009. Due to the fact the Company has the ability and intent to hold these investments until a market price recovery or maturity and it is unlikely that the Company will be required to sell the security before recovery of their amortized cost; 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, 2008, follows:

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| (in thousands) | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| Obligations of states and political subdivisions | 4,888 | (197) | 5,454 | (161) | 10,342 | (358) |
| Mortgage-backed securities | 1,638 | (30) | 30 | — | 1,668 | (30) |
| Total | $6,526 | $(227) | $5,484 | $(161) | $12,010 | $(388) |

No decline in value was considered “other-than-temporary” during 2008. Twenty securities that had a fair market value of $6,526 and a total unrealized loss of $227 have been in an unrealized loss position for less than twelve months as of December 31, 2008. In addition, fifteen securities with a fair market value of $5,484 and a total unrealized loss of $161 that have been in an unrealized loss position for more than twelve months as of December 31, 2008. Due to the fact the Company has the ability and intent to hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

Investment securities carried at $31,999 September 30, 2009 and $21,071 at December 31, 2008, were pledged to secure public deposits or for other purposes as required or permitted by law.

12. SUBSEQUENT EVENTS

Management performed an evaluation of the Company's activity through the filing date of the quarterly 10-Q with the Securities and Exchange Commission on November 9, 2009, and has concluded that there are no significant subsequent events requiring disclosure or recognition through the date these financial statements were issued.

FIRST NORTHERN COMMUNITY BANCORP

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

### FORWARD-LOOKING STATEMENTS

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and subject to the "safe harbor" created by those sections. Forward-looking statements include the information concerning possible or assumed future results of operations of the Company set forth under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report. Forward-looking statements also include statements in which words such as "expect," "anticipate," "intend," "plan," "believe," estimate," "consider" or similar expressions are used, and include assumptions concerning the Company's operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from those set forth in or implied by the forward-looking statements and related assumptions. Some factors that may cause actual results to differ from the forward-looking statements include the following: (i) the effect of changing regional and national economic conditions, including the continuing fiscal challenges for the State of California and the financial crisis affecting the banking system and financial markets; (ii) uncertainty regarding the economic outlook resulting from the continuing hostilities in the Middle East and the war on terrorism, as well as actions taken or to be taken by the United States or other governments as a result of further acts or threats of terrorism; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of commercial, agricultural, real estate, consumer and other lending activities; (v) adverse effects of current and future federal and state banking or other laws and regulations or governmental fiscal or monetary policies including legislative responses to the financial crisis affecting the banking system and financial markets; (vi) competition in the banking industry; (vii) deposit migration trends and changes in demand for loan products and other bank products; (viii) changes in accounting standards; (ix) our participation in the U.S. Treasury TARP Capital Purchase Program; and (x) other external developments which could materially impact the Company's operational and financial performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2008 and Item 1A. of Part II of this Report.

The following is a discussion and analysis of the significant changes in the Company's Unaudited Condensed Consolidated Balance Sheets and of the significant changes in income and expenses reported in the Company's Unaudited Condensed Consolidated Statements of Income and Stockholders' Equity and Comprehensive Income as of and for the nine-month periods ended September 30, 2009 and 2008 and should be read in conjunction with the Company's consolidated 2008 financial statements and the notes thereto contained in the Company's Annual Report to Stockholders and Form 10-K for the year ended December 31, 2008, along with other financial information included in this Report.

INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this Report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire Report, together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2008.

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

Significant results and developments during the third quarter and year-to-date 2009 include:

- Net income of $1.56 million for the nine months ended September 30, 2009, up 818% from the $0.17 million for the same fiscal period last year.

- Diluted income per share for the nine months ended September 30, 2009 was $0.11, up 450% from the diluted income per share of $0.02 reported in the same period last year (per share data has been adjusted for stock dividends).

- Net interest income decreased in the nine months ended September 30, 2009 by $3.7 million, or 14.6%, to $21.4 million from $25.0 million in the same period last year. The decrease in net interest income was primarily attributable to a decrease in interest yields, which was partially offset by a decrease in interest costs. Net interest margin decreased from 5.43% for the nine-month period ending September 30, 2008 to 4.61% for the same period ending September 30, 2009.

Provision for loan losses of $3.9 million for the nine-month period ended September 30, 2009 compared to a provision for loan losses of $10.1 million for the same period in 2008. The decrease in the provision for loan losses during the nine-month period in 2009 was primarily due to normalization in collateral values which was partially offset by the repayment abilities of some of the Bank's customers centered in the Company's residential construction and construction related commercial segment of the loan portfolio affected by the repercussions of the country's housing market crisis.

- Total assets at September 30, 2009 were $730.0 million, an increase of $72.5 million, or 11.0%, from levels at September 30, 2008.

- Total net loans at September 30, 2009 (including loans held-for-sale) decreased $44.7 million, or 8.4%, to $485.6 million compared to September 30, 2008.

- Total investment securities at September 30, 2009 increased $43.7 million, or 100.5%, to $87.2 million compared to September 30, 2008.

- Total deposits of $630.2 million at September 30, 2009, represented an increase of $71.0 million, or 12.7%, compared to September 30, 2008. We believe a primary reason for the increase in deposits was depositor movement from troubled financial institutions and the stock market and the Company's standing in the communities it serves. Since the peak in the real estate market, deposits in the real estate related business accounts show consistent reduction in average and end of period balances while the number of customers has remained stable.
- Net income for the quarter of $0.53 million, down 45.4% from the $0.97 million earned in the third quarter of 2008.

- Diluted earnings per share for the quarter of $0.03 compared to $0.11 per diluted share earned a year ago.

SUMMARY

The Company recorded net income of $1,560,000 for the nine-month period ended September 30, 2009, representing an increase of $1,392,000 from net income of $168,000 for the same period in 2008.

The following table presents a summary of the results for the three-month and nine-month periods ended September 30, 2009 and 2008.

| | (in thousands, except per share and percentage) | | | |
|---|---|---|---|---|
| | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
| For the Period: | | | | |
| Net Income | $531 | $972 | $1,560 | $168 |
| Basic Earnings Per Common Share* | $0.03 | $0.11 | $0.11 | $0.02 |
| Diluted Earnings Per Common Share* | $0.03 | $0.11 | $0.11 | $0.02 |
| At Period End: | | | | |
| Total Assets | 729,956 | 657,523 | 729,956 | 657,523 |
| Total Loans, Net (including loans held-for-sale) | 485,609 | 530,322 | 485,609 | 530,322 |
| Total Investment Securities | 87,218 | 43,452 | 87,218 | 43,452 |
| Total Deposits | 630,192 | 559,222 | 630,192 | 559,222 |
| Loan-To-Deposit Ratio | 77.1 | 94.8 | 77.1 | 94.8 |

*Adjusted for stock dividends

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, 2009 | | | Three months ended September 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) | $ 492,919 | $ 7,545 | 6.07 % | $ 530,220 | $ 9,062 | 6.78 % |
| Federal funds sold | 58,661 | 19 | 0.13 % | 15,044 | 70 | 1.85 % |
| Interest bearing due from banks | 12,553 | 28 | 0.88 % | 10,261 | 109 | 4.21 % |
| Investment securities, taxable | 45,868 | 353 | 3.05 % | 23,175 | 282 | 4.83 % |
| Investment securities, non-taxable (2) | 23,454 | 247 | 4.18 % | 28,248 | 300 | 4.21 % |
| Other interest earning assets | 2,506 | 4 | 0.63 % | 2,271 | 33 | 5.77 % |
| Total interest-earning assets | 635,961 | 8,196 | 5.11 % | 609,219 | 9,856 | 6.42 % |
| Non-interest-earning assets: | | | | | | |
| Cash and due from banks | 41,966 | | | 22,521 | | |
| Premises and equipment, net | 7,504 | | | 8,096 | | |
| Other real estate owned | 2,934 | | | 5,630 | | |
| Accrued interest receivable and other assets | 29,170 | | | 25,992 | | |
| Total average assets | 717,535 | | | 671,458 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing transaction deposits | 126,346 | 146 | 0.46 % | 128,313 | 208 | 0.64 % |
| Savings and MMDA's | 173,148 | 353 | 0.81 % | 171,971 | 422 | 0.97 % |
| Time, under $100,000 | 57,472 | 218 | 1.50 % | 45,811 | 214 | 1.85 % |
| Time, $100,000 and over | 93,817 | 438 | 1.85 % | 61,658 | 438 | 2.82 % |
| FHLB advances and other borrowings | 11,770 | 109 | 3.67 % | 28,271 | 247 | 3.47 % |
| Total interest-bearing liabilities | 462,553 | 1,264 | 1.08 % | 436,024 | 1,529 | 1.39 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Non-interest-bearing liabilities: | | | | | | |
| Non-interest-bearing demand deposits | 169,037 | | | 167,339 | | |
| Accrued interest payable and other liabilities | 6,556 | | | 6,178 | | |
| Total liabilities | 638,146 | | | 609,541 | | |
| Total stockholders' equity | 79,389 | | | 61,917 | | |
| Total average liabilities and stockholders' equity | $ 717,535 | | | $ 671,458 | | |
| Net interest income and net interest margin (3) | | $ 6,932 | 4.32 % | | $ 8,327 | 5.42 % |

1. Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-accrued interest thereon is excluded. Loan interest income includes loan fees of approximately $308 and $409 for the three months ended September 30, 2009 and 2009, respectively.
2. Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.
3. Net interest margin is computed by dividing net interest income by total average interest-earning assets.

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FIRST NORTHERN COMMUNITY BANCORP

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

| | Nine months ended September 30, 2009 | | | Nine months ended September 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) | $ 494,117 | $ 23,315 | 6.31 % | $ 507,804 | $ 26,842 | 7.04 % |
| Federal funds sold | 61,392 | 58 | 0.13 % | 25,996 | 487 | 2.50 % |
| Interest bearing due from banks | 5,897 | 88 | 2.00 % | 16,524 | 521 | 4.20 % |
| Investment securities, taxable | 31,368 | 820 | 3.50 % | 30,602 | 1,122 | 4.88 % |
| Investment securities, non-taxable (2) | 24,256 | 765 | 4.22 % | 31,398 | 986 | 4.18 % |
| Other interest earning assets | 2,422 | 10 | 0.55 % | 2,237 | 99 | 5.90 % |
| Total interest-earning assets | 619,452 | 25,056 | 5.41 % | 614,561 | 30,057 | 6.52 % |
| Non-interest-earning assets: | | | | | | |
| Cash and due from banks | 40,442 | | | 23,501 | | |
| Premises and equipment, net | 7,849 | | | 8,012 | | |
| Other real estate owned | 3,567 | | | 3,368 | | |
| Accrued interest receivable and other assets | 27,639 | | | 25,293 | | |
| Total average assets | 698,949 | | | 674,735 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing transaction deposits | 126,460 | 478 | 0.51 % | 130,451 | 758 | 0.77 % |
| Savings and MMDA's | 166,706 | 943 | 0.76 % | 174,921 | 1,419 | 1.08 % |
| Time, under $100,000 | 57,395 | 668 | 1.56 % | 44,569 | 798 | 2.39 % |
| Time, $100,000 and over | 83,032 | 1,199 | 1.93 % | 66,628 | 1,660 | 3.32 % |
| FHLB advances and other borrowings | 14,244 | 390 | 3.66 % | 15,964 | 394 | 3.29 % |
| | 447,837 | 3,678 | 1.10 % | 432,533 | 5,029 | 1.55 % |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total interest-bearing liabilities | | | | | | | | |
| Non-interest-bearing liabilities: | | | | | | | | |
| Non-interest-bearing demand deposits | 171,187 | | | | 172,669 | | | |
| Accrued interest payable and other liabilities | 6,185 | | | | 6,080 | | | |
| Total liabilities | 625,209 | | | | 611,282 | | | |
| Total stockholders' equity | 73,740 | | | | 63,453 | | | |
| Total average liabilities and stockholders' equity | $ 698,949 | | | | $ 674,735 | | | |
| Net interest income and net interest margin (3) | | $ 21,378 | 4.61 | % | | $ 25,028 | 5.43 | % |

1. Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-accrued interest thereon is excluded. Loan interest income includes loan fees of approximately $1,365 and $1,503 for the nine months ended September 30, 2009 and 2008, respectively.
2. Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.
3. Net interest margin is computed by dividing net interest income by total average interest-earning assets.

CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a $87,772,000 increase in cash and due from banks, a $40,780,000 decrease in Federal funds sold, a $45,112,000 increase in investment securities available-for-sale, a $34,578,000 decrease in net loans held-for-investment, a $1,027,000 increase in loans held-for-sale, a $380,000 increase in other real estate owned and a $341,000 increase in accrued interest receivable and other assets from December 31, 2008 to September 30, 2009. The increase in cash and due from banks was largely the result of increases in interest bearing due from banks accounts which was partially offset by a decrease in non-interest bearing due from banks accounts. The decrease in Federal funds sold was due, in large part, to increases in interest bearing due from banks accounts and investment securities available-for-sale, which was partially offset by decreases in net loans held-for-investment, and an increase in deposits. The increase in investment securities available-for-sale was primarily the result of purchases of agency mortgage-back securities and was moderately offset by a decrease in agency bonds and municipal bonds. Management evaluated the unrealized loss associated with the investment securities available-for-sale and no decline was considered “other than temporary” at September 30, 2009. Due to the fact the Company has the ability and intent to hold these investments until a market price recovery or maturity, and the unrealized loss is not due to credit worthiness, these investments are not considered other-than-temporarily impaired. The decrease in loans held-for-investment was in large part due to decreases in the following loan categories: commercial and industrial; agricultural; equipment; true equipment leases; real estate, real estate commercial and construction and real estate SBA (Small Business Administration), which were partially offset by increases in home equity loans. The increase in loans held-for-sale was in real estate loans and was due, for the most part, to an increase in the origination of loans. The Company originated approximately $87,631,000 in residential mortgage loans during the first nine months of 2009, which was offset by approximately $86,604,000 in loan sales during this period. The increase in other real estate owned was due to the addition of OREO properties, which was partially offset by a decline in the value of other real estate owned and the sale of other real estate owned properties. The increase in accrued interest receivable and other assets was mainly due to increases in accrued interest receivable, housing tax credits, cash surrender value of bank owned life insurance, accrued income taxes receivable, mortgage servicing asset, and prepaid expenses which was partially offset by decreases in suspense items.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of $45,474,000 at September 30, 2009 compared to December 31, 2008. The increase in deposits was due to increases the following deposit accounts: savings; money market; interest-bearing transaction and time deposits, which was partially offset by a decrease in demand deposit accounts. The primary reason for the increase in deposits was due to the ongoing economic impact of the deterioration of the stock market and as a result of depositor movement to federally insured deposit accounts. The decrease in demand deposit accounts is due in large part to the impact of the slowing real estate activity in the communities served by the Company. Since the peak in the real estate market, deposits in the real estate related business accounts show consistent reduction in average and end of period balances while the number of customers has remained stable. Federal Home Loan Bank advances (“FHLB advances”) and other borrowings decreased $6,383,000 for the nine months ended September 30, 2009 compared to the year ended December 31, 2008, due maturing FHLB advances.

CHANGES IN RESULTS OF OPERATIONS

Interest Income

The Federal Open Market Committee decreased the Federal Funds rate 188 basis points during the twelve-month period ended September 30, 2009.

Interest income on loans for the nine-month period ended September 30, 2009 was down 13.1% from the same period in 2008, decreasing from $26,842,000 to $23,315,000 and was down 16.7% for the three-month period ended September 30, 2009 over the same period in 2008, from $9,062,000 to $7,545,000. The decrease in interest income on loans for the nine-month period ended as compared to the same period a year ago was primarily due to a 73 basis point decrease in loan yields combined with a decrease in average loans. The decrease for the three-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 71 basis point decrease in loan yields combined with a decrease in average loans.

Interest income on investment securities available-for-sale for the nine-month period ended September 30, 2009 was down 24.8% from the same period in 2008, decreasing from $2,108,000 to $1,585,000 and was up 3.1% for the three-month period ended September 30, 2009 over the same period in 2008, from $582,000 to $600,000. The decrease in interest income on investment securities for the nine-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a decrease in average investment securities combined with a 74 basis point decrease in investment securities yields. The increase for the three-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to an increase in average investment securities, which was partially offset by a 106 basis point decrease in investment securities yields

Interest income on Federal Funds sold for the nine-month period ended September 30, 2009 was down 88.1% from the same period in 2008, decreasing from $487,000 to $58,000 and was down 72.9% for the three-month period ended September 30, 2009 over the same period in 2008, from $70,000 to $19,000. The decrease in interest income on Federal Funds for the nine-month period ended as compared to the same period a year ago was primarily due to a 237 basis point decrease in Federal Funds yields, which was partially offset by an increase in average Federal Funds sold. The decrease for the three-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 172 basis point decrease in Federal Funds yields, which was partially offset by an increase in average Federal Funds sold.

Interest income on other interest-earning assets for the nine-month period ended September 30, 2009 was down 89.9% from the same period in 2008, decreasing from $99,000 to $10,000 and was down 87.9% for the three-month period ended September 30, 2009 over the same period in 2008, decreasing from $33,000 to $4,000. The decrease in interest income on other interest-earning assets for the nine-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 535 basis point decrease in other earning asset yields, which was partially offset by an increase in average other interest earning assets. The decrease in interest income on other interest-earning assets for the three-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 514 basis point decrease in other earning asset yields, which was partially offset by an increase in average other interest earning assets.

Interest income on interest-bearing due from banks for the nine-month period ended September 30, 2009 was down 83.1% from the same period in 2008, decreasing from $521,000 to $88,000 and was down 74.3% for the three-month period ended September 30, 2009 over the same period in 2008, decreasing from $109,000 to $28,000. The decrease in interest income on interest-bearing due from banks for the nine-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 220 basis point decrease in interest-bearing due from

banks yields combined with a decrease in average interest-bearing due from banks. The decrease in interest income on interest-bearing due from banks for the three-month period ended September 30, 2009 as compared to the same period a year ago was primarily due to a 333 basis point increase in interest-bearing due from banks yields, which was partially offset by an increase in average interest-bearing due from banks.

Interest Expense

The decrease in general market interest rates decreased the Company’s cost of funds in the first nine months of 2009 compared to the same period a year ago.

Interest expense on deposits and other borrowings for the nine-month period ended September 30, 2009 was down 26.9% from the same period in 2008, decreasing from $5,029,000 to $3,678,000, and was down 17.3% for the three-month period ended September 30, 2009 over the same period in 2008 from $1,529,000 to $1,264,000. The decrease in interest expense during the nine-month period ended September 30, 2009 was primarily due to a 45 basis point decrease in the Company’s average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The decrease in interest expense during the three-month period ended September 30, 2009 was primarily due to a 31 basis point decrease in the Company’s average cost of funds, which was partially offset by an increase in average interest-bearing liabilities.

Provision for Loan Losses

There was a provision for loan losses of $3,928,000 for the nine-month period ended September 30, 2009 compared to a provision for loan losses of $10,060,000 for the same period in 2008. The allowance for loan losses was approximately $14,179,000, or 2.85% of total loans, at September 30, 2009 compared to $14,435,000, or 2.71% of total loans, at December 31, 2008. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

There was a provision for loan losses of $1,661,000 for the three-month period ended September 30, 2009 compared to a $3,638,000 provision for the same period in 2008.

The decreases in the provision for loan losses during the three-month and nine-month periods in 2009 were primarily due to stabilization in collateral values and repayment abilities of some of the Bank's customers centered in the Company's residential construction and construction-related commercial segment of the loan portfolio affected by the repercussions of the country's housing market crisis.

Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the nine-month period ended September 30, 2009 compared to a recovery of provision of $108,000 for the same period in 2008.

There was no provision for unfunded lending commitment losses for the three-month period ended September 30, 2009 compared to a recovery of provision of $104,000 for the same period in 2008.

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

Other Operating Income

Other operating income was up 9.1% for the nine-month period ended September 30, 2009 from the same period in 2008 increasing from $5,921,000 to $6,459,000.

This increase was primarily due to increases in loan servicing income, gains on sales of loans held-for-sale, and mortgage brokerage income, which was partially offset by decreases in gains on available-for-sale securities, service charges on deposit accounts, gains on sales of other real estate owned, and other miscellaneous income. The increases in loan servicing income, gains on sales of loans held-for-sale and mortgage brokerage income were the result of increased residential mortgage activity. The decrease in gains on available-for-sale securities was due to a higher level of sales during the first nine months of 2008, compared to the first nine months of 2009. The decrease in service charges on deposit accounts was due to a decrease in overdraft fees. The decrease in gains on sales of other real estate owned was due to a higher level of gains during the first nine months of 2008, compared to the first nine months of 2009. The decrease in other miscellaneous income was due to decreases in standby letters of credit fees.

Other operating income was up 22.0% for the three-month period ended September 30, 2009 from the same period in 2008, increasing from $1,846,000 to $2,252,000.

This increase was primarily due to increases in loan servicing income, gains on sales of loans held-for-sale, mortgage brokerage income, and investment brokerage services income, which was partially offset by decreases in gains on sales of other real estate owned, service charges on deposit accounts, and gains on available-for-sale securities. The increases in gains on loan servicing income, sales of loans held-for-sale and mortgage brokerage income were the result of increased residential mortgage activity. The increase in investment brokerage services income was due to an increase in the demand for those services. The decrease in gains on sales of other real estate owned was due to a higher level of gains during the third quarter of 2008, compared to the third quarter of 2009. The decrease in service charges on deposit accounts was due to a decrease in overdraft fees. The decrease in gains on available-for-sale securities was due to lower sales during the third quarter of 2009, compared to sales during the third quarter of 2008.

Other Operating Expenses

Total other operating expenses was up 2.96% for the nine-month period ended September 30, 2009 from the same period in 2008, increasing from $22,287,000 to $22,947,000.

The principal reasons for the increase in other operating expenses in the nine-month period ended September 30, 2009 were increases in the following: occupancy and equipment expense; data processing; and other miscellaneous operating expense, which were partially offset by decreases in salaries and benefits, stationary and supplies, and other real estate owned expense. The increase in occupancy and equipment expense was due to increases in the following: rent expense; solar equipment rental and service contracts, which was partially offset by decreases in other equipment rental; equipment and building maintenance; bank owned vehicle expense; utilities; hazard and liability insurance expense; and depreciation on furniture and equipment and computer hardware. The increase in data processing costs was due to increased expenses associated with maintaining and monitoring the Company's data communications network and internet banking system. The decrease in salaries and benefits was due, for the most part, to decreases in the following: merit salaries; contingent sick-pay and vacation-pay; stock compensation expense; retirement compensation expense; welfare and recreation; and worker's compensation expense, which were partially offset by increases in commissions paid; profit sharing expenses due to increased profits; and deferred loan processing costs. The decrease in other real estate owned expense was due to lower write-downs and maintenance expenses related to OREO properties.

Total other operating expenses was up 0.35% for the three-month period ended September 30, 2009 from the same period in 2008, increasing from $7,136,000 to $7,161,000.

The principal reasons for the increase in other operating expenses in the three-month period ended September 30, 2009 were increases in the following: salaries and benefits; occupancy and equipment expense; and other miscellaneous operating expense, which were partially offset by a decrease in other real estate owned expense. The increase in salaries and benefits was due, for the most part, to increases in deferred loan processing costs; commissions paid; payroll taxes; and profit sharing expenses due to increased profits; which were partially offset by decreases in merit salaries; stock compensation expense; welfare and recreation; and retirement compensation expense. The increase in occupancy and equipment expense was due to increases in the following: rent expense; service contracts; other equipment rental; and solar equipment rental, which was partially offset by decreases in equipment and building maintenance; bank owned vehicle expense; utilities; hazard and liability insurance expense; and depreciation on furniture and equipment and computer hardware. The decrease in other real estate owned expense was due to lower write-downs and maintenance expenses related to OREO properties.

The following table sets forth other miscellaneous operating expenses by category for the three-month and nine-month periods ended September 30, 2009 and 2008.

| | (in thousands) | | | |
|---|---|---|---|---|
| | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
| Other miscellaneous operating expenses | | | | |
| Recovery of provision for unfunded lending commitments | $ — | $ (104) | $ — | $ (108) |
| FDIC assessments | 336 | 133 | 1,089 | 358 |
| Contributions | 41 | 39 | 80 | 109 |
| Legal fees | 52 | 47 | 237 | 225 |
| Accounting and audit fees | 140 | 92 | 379 | 429 |
| Consulting fees | 44 | 76 | 165 | 308 |
| Postage expense | 83 | 79 | 271 | 248 |
| Telephone expense | 63 | 87 | 212 | 223 |
| Public relations | 50 | 50 | 158 | 249 |
| Training expense | 23 | 43 | 68 | 167 |
| Loan origination expense | 168 | 53 | 635 | 317 |
| Computer software depreciation | 55 | 64 | 161 | 186 |
| Sundry losses (recovery of sundry losses | 33 | (63) | 158 | 95 |
| Loan collection expense | 86 | 94 | 291 | 164 |
| Other miscellaneous expense | 344 | 331 | 955 | 1,009 |
| Total other miscellaneous operating expenses | $ 1,518 | $ 1,021 | $ 4,859 | $ 3,979 |

Income Taxes

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

In the nine months ended September 30, 2009, the Company's benefit for income taxes decreased $968,000 from the same period last year, from a $1,566,000 benefit to a benefit of $598,000.

In the three months ended September 30, 2009, the Company's benefit for income taxes decreased $1,404,000 from the same period last year, from a $1,573,000 benefit to a benefit of $195,000.

The decrease in benefit for income taxes for all periods presented is primarily attributable to the respective level of earnings combined with the interim effective tax rate and the incidence of allowable deductions, in particular non-taxable municipal bond income, tax credits generated from low-income housing investments, solar tax credits, excludable interest income and, for California franchise taxes, higher excludable interest income on loans within designated enterprise zones.

Off-Balance Sheet Commitments

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

| | (in thousands) | |
|---|---|---|
| | September 30, 2009 | December 31, 2008 |
| Undisbursed loan commitments | $172,443 | $198,615 |
| Standby letters of credit | 3,747 | 5,715 |
| Commitments to sell loans | 6,201 | 9,764 |
| | $182,391 | $214,094 |

The reserve for unfunded lending commitments amounted to $1,021,000 at September 30, 2009, which was unchanged from December 31, 2008. The reserve for unfunded lending commitments is included in other liabilities.

Asset Quality

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies. The federal bank and thrift regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes: “Substandard Assets: a substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.” “Doubtful Assets: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.” Other Real Estate Owned” and loans rated Substandard and Doubtful are deemed "classified assets". This category, which includes both performing and non-performing assets, receives an elevated level of attention regarding collection.

Residential mortgage loans, which are secured by real estate, are primarily susceptible to three 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 due to loss of employment and follows general economic trends in the marketplace, particularly the upward movement in the unemployment rate, loss of collateral value, and demand shifts.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment, receivables or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resultant 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. Appropriate valuations are obtained at origination of the credit and periodically thereafter, (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

Construction loans, whether owner occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction itself including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Again,

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, the Company may pursue repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter, (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as changing weather conditions. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history and crop inspections. Based on this information, the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter, (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and other real property of the business and are susceptible to the related risks described above. Problem commercial loans are generally identified by periodic review of financial information that may include financial statements, tax returns, and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically there after, (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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

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

The following tables summarize the Company's classified assets for the periods ended September 30, 2009, June 30, 2009, March 31, 2009 and December 31, 2008:

| | At September 30, 2009 | | | At June 30, 2009 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Classified loans: | | | | | | |
| Residential mortgage | $ 5,566 | $ — | $ 5,566 | $ 4,396 | $ — | $ 4,396 |
| Residential construction | 7,812 | — | 7,812 | 11,429 | — | 11,429 |
| Commercial real estate | 30,520 | 100 | 30,420 | 32,425 | — | 32,425 |
| Agriculture | 95 | — | 95 | 152 | — | 152 |
| Commercial | 20,281 | 1,400 | 18,881 | 19,355 | 1,080 | 18,275 |
| Consumer | 2,827 | 95 | 2,732 | 2,609 | — | 2,609 |
| Total classified loans | $ 67,101 | $ 1,595 | $ 65,506 | $ 70,366 | $ 1,080 | $ 69,286 |
| Other real estate owned | 4,748 | | 4,748 | 3,172 | | 3,172 |
| Total classified assets | $ 71,849 | $ 1,595 | $ 70,254 | $ 73,538 | $ 1,080 | $ 72,458 |
| Allowance for loan losses/classified loans | | | 21.7 % | | | 20.5 % |

| | At March 31, 2009 | | | At December 31, 2008 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Classified loans: | | | | | | |
| Residential mortgage | $ 5,582 | $ — | $ 5,582 | $ 4,532 | $ — | $ 4,532 |
| Residential construction | 15,188 | — | 15,188 | 13,750 | — | 13,750 |
| Commercial real estate | 32,417 | — | 32,417 | 14,645 | 111 | 14,534 |
| Agriculture | 177 | — | 177 | 32 | — | 32 |
| Commercial | 16,232 | 617 | 15,615 | 18,496 | 363 | 18,133 |
| Consumer | 1,588 | — | 1,588 | 1,157 | — | 1,157 |
| Total classified loans | $ 71,184 | $ 617 | $ 70,567 | $ 52,612 | $ 474 | $ 52,138 |
| Other real estate owned | 3,657 | | 3,657 | 4,368 | | 4,368 |
| Total classified assets | $ 74,841 | $ 617 | $ 74,224 | $ 56,978 | $ 474 | $ 56,506 |
| Allowance for loan losses/classified loans | | | 20.5 % | | | 27.7 % |

Classified assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased $2,204,000, or 3.0% to $70,254,000 at September 30, 2009 from $72,458,000 at June 30, 2009. The guarantees noted above are provided by various government agencies including the Small Business Administration and California Capital Access Program (CalCAP). These guarantees range from approximately 60% to 85% of the loan amount with the majority at 80% or higher. We consider these guarantees when considering the adequacy of the loan loss allowance. The decrease in classified assets during the third quarter of 2009 was primarily due to decreases in the following categories; residential construction loans, commercial real estate loans and agricultural loans, which was partially offset by increases in the amount of classified assets in the following categories; residential mortgage loans, commercial loans, consumer loans and other real estate owned.

The increase in classified assets during the nine months ended September 30, 2009 was primarily due to increases in the following categories; residential construction loans, commercial real estate loans, agricultural loans, commercial loans, consumer loans, and other real estate owned, which was partially offset by a decrease in the amount of classified assets in the following category; residential construction loans.

Classified assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, increased $13,748,000 or 24.3% to $70,254,000 at September 30, 2009 from $56,506,000 at December 31, 2008.



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The following tables summarize the Company's non-accrual loans by loan category at September 30, 2009, June 30, 2009, March 31, 2009 and December 31, 2008.

| | At September 30, 2009 | | | At June 30, 2009 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Residential mortgage | $ 947 | $ — | $ 947 | $ 469 | $ — | $ 469 |
| Residential construction | 3,961 | — | 3,961 | 6,953 | — | 6,953 |
| Commercial real estate | 3,667 | — | 3,666 | 6,778 | — | 6,778 |
| Agriculture | — | — | — | 129 | — | 129 |
| Commercial | 1,567 | 792 | 776 | 1,076 | 386 | 690 |
| Consumer | 99 | — | 99 | 99 | — | 99 |
| Total non-accrual loans | $ 10,241 | $ 792 | $ 9,449 | $ 15,504 | $ 386 | $ 15,118 |

| | At March 31, 2009 | | | At December 31, 2008 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Residential mortgage | $ 471 | $ — | $ 471 | $ 334 | $ — | $ 334 |
| Residential construction | 6,874 | — | 6,874 | 6,309 | — | 6,309 |
| Commercial real estate | 7,498 | — | 7,498 | 5,233 | — | 5,233 |
| Agriculture | 177 | — | 177 | — | — | — |
| Commercial | 1,779 | 107 | 1,672 | 1,570 | 109 | 1461 |
| Consumer | 99 | — | 99 | 99 | — | 99 |
| Total non-accrual loans | $ 16,898 | $ 107 | $ 16,791 | $ 13,545 | $ 109 | $ 13,436 |

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

Non-accrual loans amounted to $10,241,000 at September 30, 2009 and were comprised of eight commercial loans totaling $1,567,000, one consumer loan totaling $99,000, six commercial real estate loans totaling $3,667,000, eighteen residential construction loans totaling $3,961,000 and four residential mortgage loans totaling $947,000. At December 31, 2008, non-accrual loans amounted to $13,545,000 and were comprised of five commercial loans

totaling $1,570,000, seven commercial real estate loans totaling $5,233,000, eleven residential construction loans totaling $6,309,000, one residential mortgage loan totaling $334,000, and one consumer loan totaling $99,000. Non-accrual loans amounted to $11,138,000 at September 30, 2008 and were comprised of one commercial loan totaling $14,000, two agricultural loans totaling $297,000, two consumer loans totaling $141,000 and twenty-three real estate loans totaling $10,686,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan for which the Company does not expect to collect by writing the loan down to fair value.

Total impaired loans at September 30, 2009, consisting of loans on non-accrual status, totaled $10,241,000; the majority of the impaired loans were in management's opinion adequately collateralized based on recently obtained appraised property values or guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

As the following table illustrates, total non-performing assets net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased $4,320,000 or 23.3% to $14,197,000 during the first nine months of 2009. Nonperforming assets net of guarantees represent 1.9% of total assets at September 30, 2009.

| (dollars in thousands) | At September 30, 2009 | | | At June 30, 2009 | | |
|---|---|---|---|---|---|---|
| | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Non-accrual loans | $ 10,241 | $ 792 | $ 9,449 | $ 15,504 | $ 386 | $ 15,118 |
| Loans 90 days past due and still accruing | — | — | — | — | — | — |
| Total non-performing loans | 10,241 | 792 | 9,449 | 15,504 | 386 | 15,118 |
| Other real estate owned | 4,748 | — | 4,748 | 3,172 | — | 3,172 |
| Total non-performing assets | 14,989 | 792 | 14,197 | 18,676 | 386 | 18,290 |
| Non-performing loans to total loans | | | 2.0 % | | | 3.1 % |
| Non-performing assets to total assets | | | 1.9 % | | | 2.6 % |
| Allowance for loan and lease losses to nonperforming loans | | | 150.1 % | | | 93.8 % |

| (dollars in thousands) | At March 31, 2009 | | | At December 31, 2008 | | |
|---|---|---|---|---|---|---|
| | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Non-accrual loans | $ 16,898 | $ 107 | $ 16,791 | $ 13,545 | $ 109 | $ 13,436 |
| Loans 90 days past due and still accruing | 2,511 | — | 2,511 | 713 | — | 713 |
| Total non-performing loans | 19,409 | 107 | 19,302 | 14,258 | 109 | 14,149 |
| Other real estate owned | 3,657 | — | 3,657 | 4,368 | — | 4,368 |
| Total non-performing assets | 23,066 | 107 | 22,959 | 18,626 | 109 | 18,517 |
| Non-performing loans to total loans | | | 4.0 % | | | 2.7 % |
| Non-performing assets to total assets | | | 3.3 % | | | 2.8 % |

| | | |
|---|---|---|
| Allowance for loan and lease losses to nonperforming loans | 74.9 % | 102.0 % |

The Company had loans 90 days past due and still accruing totaling $0, $1,919,000 and $713,000 at September 30, 2009 and 2008 and December 31, 2008, respectively.

Non-performing assets is comprised of non-performing loans, discussed above, and other real estate owned. OREO is made up of property that the Company has acquired by deed in lieu of foreclosure or through foreclosure proceedings, and property that the Company does not hold title to but is in actual control of, known as in-substance foreclosure. The estimated fair value of the property is determined prior to transferring the balance to OREO. The balance transferred to OREO is the lesser of the estimated fair market value of the property, or the book value of the loan, less estimated cost to sell. A write-down may be deemed necessary to bring the book value of the loan equal to the appraised value. Appraisals or loan officer evaluations are then done periodically thereafter charging any additional write-downs to the appropriate expense account.

OREO amounted to $4,748,000, $4,725,000, and $4,368,000 for the periods ended September 30, 2009 and 2008, and December 31, 2008, respectively. The increase in OREO at September 30, 2009 from the balance at December 31, 2008 was due, for the most part, to an increase in other real estate owned which was partially offset by write-downs and sales of OREO properties.

The Company had loans restructured and in compliance with modified terms totaling $8,631,000, $423,000 and $2,682,000 at September 30, 2009 and 2008 and December 31, 2008, respectively.

Allowance for Loan Losses

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

The following table summarizes the loan loss experience of the Company for the nine-month periods ended September 30, 2009 and 2008, and for the year ended December 31, 2008.

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

| | Nine months ended September 30, | | Year ended December 31, |
|---|---|---|---|
| | 2009 | 2008 | 2008 |
| Balance at beginning of period | $14,435 | $10,876 | $10,876 |
| Provision for loan losses | 3,928 | 10,060 | 16,164 |
| Loans charged-off: | | | |
| Commercial | (1,221) | (537) | (2,224) |
| Agriculture | — | — | (88) |
| Real estate mortgage | (1,328) | (1,909) | (299) |
| Real estate construction | (2,249) | (5,271) | (10,265) |
| Consumer loans to individuals | (281) | (292) | (448) |
| Total charged-off | (5,079) | (8,009) | (13,324) |
| Recoveries: | | | |
| Commercial | 12 | 150 | 153 |
| Agriculture | — | 51 | 56 |
| Real estate mortgage | — | 57 | 32 |
| Real estate construction | 697 | — | 159 |
| Consumer loans to individuals | 186 | 253 | 319 |
| Total recoveries | 895 | 511 | 719 |
| Net charge-offs | (4,184) | (7,498) | (12,605) |
| Balance at end of period | $14,179 | $13,438 | $14,435 |
| Ratio of net charge-offs | | | |
| To average loans outstanding during the period | (0.83%) | (1.45%) | (2.40%) |
| Allowance for loan losses | | | |
| To total loans at the end of the period | 2.85% | 2.46% | 2.71% |
| To non-performing loans at the end of the period | 138.45% | 111.65% | 101.24% |

Non-performing loans totaled $10,241,000, $12,036,000, and $14,258,000 at September 30, 2009 and 2008, and December 31, 2008, respectively.

Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2009, the Company had the following deposit mix: 28.7% in savings and MMDA deposits, 24.9% in time deposits, 19.7% in interest-bearing transaction deposits and 26.7% in non-interest-bearing transaction deposits. Non-interest-bearing transaction deposits enhance the Company's net interest income by lowering its cost of funds.

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

Maturities of time certificates of deposits of $100,000 or more outstanding at September 30, 2009 and December 31, 2008 are summarized as follows:

| | (in thousands) | |
|---|---|---|
| | September 30, 2009 | December 31, 2008 |
| Three months or less | $37,704 | $27,753 |
| Over three to twelve months | 50,651 | 26,595 |
| Over twelve months | 10,519 | 5,248 |
| Total | $98,874 | $59,596 |

We believe the increase in time certificates of deposit (CD's) of $100,000 or more is primarily attributable to the lack of investor confidence in the stock market.

Liquidity and Capital Resources

In order to serve our market area, the Company must maintain adequate liquidity and adequate capital. Liquidity is measured by various ratios with the most common being the ratio of net loans to deposits (including loans held-for-sale). This ratio was 77.1% on September 30, 2009. In addition, on September 30, 2009, the Company had the following short-term investments: $750,000 in Certificate of Deposit Account Registry Service ("CDARS"); $2,960,000 in securities due within one year; and $3,003,000 in securities due in one to five years.

To meet unanticipated funding requirements, the Company maintains short-term unsecured lines of credit with other banks totaling $17,000,000 at September 30, 2009; additionally the Company has a line of credit with the Federal Home Loan Bank, on which the current borrowing capacity is $117,538,000.

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

As of September 30, 2009, the Bank's capital ratios exceeded applicable regulatory requirements. The following table presents the capital ratios for the Bank, compared to the standards for well-capitalized depository institutions, as of September 30, 2009.

| (amounts in thousands except percentage amounts) | | |
|---|---|---|
| Actual | Adequately Capitalized | Well Capitalized Ratio |

| | Capital | Ratio | Ratio | Requirement |
|---|---|---|---|---|
| Leverage | $75,961 | 10.62 % | 4.0 % | 5.0 % |
| Tier 1 Risk-Based | $75,961 | 14.32 % | 4.0 % | 6.0 % |
| Total Risk-Based | $82,696 | 15.59 % | 8.0 % | 10.0 % |

CPP Participation

On March 13, 2009 the Company received $17,390,000 from the U.S. Treasury in exchange for 17,390 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value $0.01 per share (Preferred Shares) and a warrant to purchase 352,977 shares of common stock at $7.39 per share under the Capital Purchase Program (CPP). The Company used the proceeds from this sale, net of issuance costs and expenses, for general working capital. The Preferred Shares and Warrant qualify as Tier 1 capital for regulatory purposes. The Preferred Shares rank senior to common stock and bear a cumulative dividend rate of five percent per annum for the first five years they are outstanding and a rate of nine percent per annum thereafter. The Preferred Shares have no maturity date and rank senior to the Common Stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution and winding up of the Company. Subject to the approval of the Board of Governors of the Federal Reserve System, the Preferred Shares are redeemable at the option of the Company at any time at 100% of their liquidation preference.

The U.S. Treasury may not transfer a portion or portions of the warrant with respect to, and/or exercise the warrant for more than one-half of, the 352,977 shares of common stock issuable upon exercise of the warrant, in the aggregate, until the earlier of (i) the date on which the Company has redeemed the Preferred Shares and (ii) December 31, 2009. In the event the Company redeems the Preferred Shares pursuant to the terms of the CPP prior to December 31, 2009, the number of the shares of common stock underlying the portion of the warrant then held by the U.S. Treasury will be reduced by one-half of the shares of common stock originally covered by the warrant. If we redeem the Preferred Shares, we will also have the right to repurchase the warrant at fair market value pursuant to procedures established by the U.S. Treasury.

The Purchase Agreement pursuant to which the Preferred Shares and the warrant were sold contains limitations on the payment of dividends on Common Stock, including with respect to the payment of cash dividends (but does not affect our ability to declare and pay stock dividends) and on the Company's ability to repurchase its common stock, and subjects the Company to certain of the executive compensation limitations included in Emergency Economic Stabilization Act of 2008. As a condition to the closing of the transaction, each of Owen J. Onsum, Louise A. Walker, Patrick S. Day and Robert M. Walker, the Company's Senior Executive Officers (as defined in the Purchase Agreement), executed a voluntary waiver of any claim against the U.S. Treasury or the Company for any changes to such Senior Executive Officer's compensation or benefits that are required to comply with the regulations issued by the U.S. Treasury under the CPP as published in the Federal Register on October 20, 2008 and acknowledging that the regulation may require modification of the compensation, bonus, incentive and other benefit plans, arrangements and policies and agreements (including so-called "golden parachute" agreements) as they relate to the period the U.S. Treasury holds any equity or debt securities of the Company acquired through the TARP Capital Purchase Program.

On June 10, 2009, the U.S. Treasury issued regulations implementing the compensation requirements under the American Recovery and Reinvestment Act of 2009 (ARRA), which amended the requirements of the Emergency Economic Stabilization Act of 2008. As a participant in the TARP Capital Purchase Program, the Company is subject to these regulations. These regulations generally supersede the executive compensation restrictions under the Purchase Agreement. These regulations provide for review of prior compensation, restrictions on paying or accruing bonuses, retention awards or incentive compensation for certain employees, regular review of all employee compensation arrangements by our Compensation Committee to ensure that the arrangements do not encourage unnecessary and excessive risk-taking or manipulation of reporting earnings, recoupment of bonus payments based on materially inaccurate information, prohibition on severance or change in control payments for certain employees, and required adoption of policies and procedures to avoid excessive luxury expenses. The regulations also prohibit tax gross-ups for certain employees and require additional disclosures relating to perquisites and compensation consultants.

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

The Company believes that there have been no material changes in the quantitative and qualitative disclosures about market risk as of September 30, 2009, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008, which are incorporated by reference herein.

## ITEM 4. – CONTROLS AND PROCEDURES

Our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) have concluded that the design and operation of our disclosure controls and procedures are effective as of September 30, 2009. This conclusion is based on an evaluation conducted under the supervision and with the participation of management. Disclosure controls and procedures are those controls and procedures which ensure that information required to be disclosed in this filing is accumulated and communicated to management and is recorded, processed, summarized, and reported in a timely manner and in accordance with Securities and Exchange Commission rules and regulations.

During the quarter ended September 30, 2009, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

# PART II – OTHER INFORMATION

## ITEM 1A. – RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the risk factors set forth below and factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2008, as supplemented by Part II, "Item 1A. Risk Factors" in our quarterly report on Form 10-Q for the quarters ended March 31, 2009 and June 30, 2009, which could materially affect our business, financial condition or future results.

## ITEM 6. – EXHIBITS

| Exhibit Number | Exhibit |
|---|---|
| 31.1 | Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

## SIGNATURES

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

FIRST NORTHERN COMMUNITY BANCORP

Date: November 9, 2009 By:/s/ Louise A. Walker

Louise A. Walker, Sr. Executive Vice President / Chief Financial Officer
(Principal Financial Officer and Duly Authorized Officer)

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