FIRST NORTHERN COMMUNITY BANCORP
Form 10-Q
November 10, 2011

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, 2011

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 x 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). See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 10, 2011 was 9,116,316.

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PART I – FINANCIAL INFORMATION

FIRST NORTHERN COMMUNITY BANCORP

ITEM I – FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands, except shares and share amounts)	September 30, 2011 (unaudited)	December 31, 2010
Assets		
Cash and cash equivalents	$149,464	$139,707
Investment securities – available-for-sale	138,749	107,346
Loans, net of allowance for loan losses of $11,437 at September 30, 2011 and $11,039 at December 31, 2010	428,015	442,015
Loans held-for-sale	3,419	2,345
Stock in Federal Home Loan Bank and other equity securities, at cost	3,075	2,823
Premises and equipment, net	8,038	8,035
Other real estate owned	2,587	2,682
Interest receivable and other assets	33,306	32,264
Total Assets	$766,653	$737,217
Liabilities and Stockholders' Equity		
Liabilities:		
Demand deposits	$195,321	$180,382
Interest-bearing transaction deposits	156,276	146,579
Savings and MMDA's	207,990	204,360
Time, under $100,000	38,188	40,083
Time, $100,000 and over	64,997	68,854
Total deposits	662,772	640,258
Federal Home Loan Bank advances and other borrowings	8,500	10,529
Interest payable and other liabilities	6,933	6,834
Total liabilities	678,205	657,621
Stockholders' Equity:		
Preferred stock, par value $0.01 per share; $1,000 per share liquidation preference, 18,500 shares authorized; no shares outstanding at September 30, 2011 and 17,390 shares outstanding at December 31, 2010	—	16,944
Preferred stock, no par value; $1,000 per share liquidation preference, 22,847 shares authorized; 22,847 issued and outstanding at		

September 30, 2011 and no shares outstanding at December 31, 2010	22,847	—
Common stock, no par value; 16,000,000 shares authorized; 9,116,316 shares issued and outstanding at September 30, 2011 and 9,103,158 shares issued and outstanding at December 31, 2010	62,997	62,869
Additional paid in capital	977	977
Retained earnings (accumulated deficit)	1,002	(401)
Accumulated other comprehensive income (loss), net	625	(793)
Total stockholders' equity	88,448	79,596
Total Liabilities and Stockholders' Equity	$766,653	$737,217

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands, except per share amounts)	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Interest and dividend income:				
Loans	$6,480	$6,892	$19,083	$20,454
Due from banks interest bearing accounts	72	102	248	284
Investment securities				
Taxable	663	465	1,921	1,247
Non-taxable	106	127	325	568
Other earning assets	2	—	6	3
Total interest and dividend income	7,323	7,586	21,583	22,556
Interest expense:				
Deposits	524	734	1,649	2,600
Other borrowings	72	92	253	307
Total interest expense	596	826	1,902	2,907
Net interest income	6,727	6,760	19,681	19,649
Provision for loan losses	1,190	990	3,670	3,303
Net interest income after provision for loan losses	5,537	5,770	16,011	16,346
Other operating income:				
Service charges on deposit accounts	723	861	2,136	2,528
Gains on sales of other real estate owned	13	2	228	46
Gains on sales of loans held-for-sale	176	329	444	625
Investment and brokerage services income	365	237	905	728
Mortgage brokerage income	12	25	39	35
Loan servicing income (expense)	5	(12)	393	367
Fiduciary activities income	99	75	285	217
ATM fees	125	74	349	208
Signature based transaction fees	248	209	692	583
Gains on sales of available-for-sale securities	177	—	633	353
Other income	511	185	903	627
Total other operating income	2,454	1,985	7,007	6,317
Other operating expenses:				
Salaries and employee benefits	3,885	3,636	11,219	11,194
Occupancy and equipment	738	786	2,370	2,444
Data processing	443	461	1,227	1,317
Stationery and supplies	67	59	230	217
Advertising	137	128	422	404
Directors' fees	52	51	176	157
Other real estate owned expense and impairment	148	328	662	772
Other expense	1,318	1,557	3,702	4,841

Total other operating expenses	6,788	7,006	20,008	21,346
Income before income tax expense (benefit)	1,203	749	3,010	1,317
Income tax expense (benefit)	255	(8)	501	(400)
Net income	$948	$757	$2,509	$1,717
Preferred stock dividends and accretion	$(607)	$(248)	$(1,106)	$(743)
Net income available to common stockholders	$341	$509	$1,403	$974
Basic income per share	$0.04	$0.06	$0.15	$0.11
Diluted income per share	$0.04	$0.06	$0.15	$0.11

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (UNAUDITED)

(in thousands, except share data)

	Preferred Stock		Common Stock		Comprehensive	Additional Paid-in	(Accumulated Deficit)/ Retained	Accumulated Other Comprehensive (Loss)	
	Shares	Amounts	Shares	Amounts	Income	Capital	Earnings	Income	Total
Balance at December 31, 2010	17,390	$16,944	9,103,158	$62,869		$977	$ (401)	$ (793)	$79,596
Comprehensive income:									
Net income					$ 2,509		2,509		2,509
Other comprehensive income, net of tax:									
Unrealized holding gains on securities arising during the current period, net of tax effect of $1,198					1,798				
Reclassification adjustment due to gains realized on sales of securities, net of tax effect of $253					(380)				
Total other comprehensive income, net of tax effect of $945					1,418			1,418	1,418

Comprehensive income					$ 3,927				
Issuance of preferred stock	22,847	22,847							22,847
Redemption of preferred stock	(17,390)	(17,390)							(17,390)
Dividend on preferred stock							(660)		(660)
Discount accretion on preferred stock		446					(446)		—
Stock-based compensation and related tax benefits				128					128
Common shares issued			13,158						
Balance at September 30, 2011	22,847	$22,847	9,116,316	$62,997		$977	$ 1,002	$ 625	$88,448

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	(in thousands)	
	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Cash Flows From Operating Activities		
Net Income	$2,509	$ 1,717
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	554	598
Provision for loan losses	3,670	3,303
Stock plan accruals	128	201
Gains on sales of available-for-sale securities	(633)	(353)
Gains on sales of other real estate owned	(228)	(46)
Impairment on other real estate owned	431	618
Gains on sales of loans held-for-sale	(444)	(625)
Proceeds from sales of loans held-for-sale	23,412	39,724
Originations of loans held-for-sale	(24,042)	(41,551)
Changes in assets and liabilities:		
(Increase) decrease in interest receivable and other assets	(1,987)	1,761
Increase in interest payable and other liabilities	99	333
Net cash provided by operating activities	3,469	5,680
Cash Flows From Investing Activities		
Net increase in investment securities	(28,407)	(17,411)
Net decrease in loans	7,133	18,345
Net increase in stock in Federal Home Loan Bank and other equity securities, at cost	(252)	(316)
Proceeds from the sale of other real estate owned	3,089	1,935
Purchases of premises and equipment, net	(557)	(93)
Net cash (used in) provided by investing activities	(18,994)	2,460
Cash Flows From Financing Activities		
Net increase (decrease) in deposits	22,514	(20,657)
Net decrease in FHLB advances and other borrowings	(2,029)	(1,878)
Proceeds from issuance of preferred stock	22,847	—
Redemption of preferred stock	(17,390)	—
Cash dividends paid on preferred stock	(660)	(652)
Net cash provided by (used in) financing activities	25,282	(23,187)
Net increase (decrease) in Cash and Cash Equivalents	9,757	(15,047)
Cash and Cash Equivalents, beginning of period	139,707	147,076
Cash and Cash Equivalents, end of period	$149,464	$ 132,029
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		

Interest	$1,937	$ 3,022
Income Taxes	$1,067	$ 154
Supplemental disclosures of non-cash investing and financing activities:		
Preferred stock dividend payable and accretion	$446	$ 202
Transfer of loans held-for-investment to other real estate owned	$3,197	$ 1,627
Unrealized holding gains on available for sale securities, net of taxes	$1,418	$ 561

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2011 and 2010 and December 31, 2010

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of First Northern Community Bancorp (the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Articles 9 and 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for any interim period are not necessarily indicative of results expected for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission. The preparation of financial statements in conformity with GAAP also requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. All material intercompany balances and transactions have been eliminated in consolidation.

Recently Issued Accounting Pronouncements:

In January 2011, FASB issued Accounting Standards Update (ASU) 2011-01. This update temporarily delays the effective date of the disclosures about troubled debt restructurings required in FASB ASC Topic 310, "Receivables." The disclosures about troubled debt restructurings for public entities are effective for the first interim or annual period beginning on or after June 15, 2011. Adoption of the new guidance did not have a significant impact on the Company's consolidated financial statements.

In April 2011, FASB issued ASU 2011-02. This update provides additional guidance in determining whether a restructuring constitutes a troubled debt restructuring. In evaluating whether a restructuring is a troubled debt restructuring, a creditor must separately conclude that the restructuring constitutes a concession and the debtor is experiencing financial difficulties. The amendment clarifies the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. The amendments in this update are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. Adoption of the new guidance did not have a significant impact on the Company's consolidated financial statements.

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

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

Reclassifications

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

2. LOANS

The composition of the Company’s loan portfolio is as follows:

($ in thousands)	September 30, 2011	December 31, 2010
Commercial	$81,455	$82,815
Commercial Real Estate	178,153	186,405
Agriculture	55,762	53,040
Residential Mortgage	50,239	52,347
Residential Construction	8,126	10,246
Consumer	65,558	68,374
	439,293	453,227
Allowance for loan losses	(11,437)	(11,039)
Net deferred origination fees and costs	159	(173)
Loans, net	$428,015	$442,015

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

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

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment, receivables or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

Construction loans, whether owner occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction, including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, or repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

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

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

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

As of September 30, 2011, approximately 41% in principal amount of the Company's loans were secured by commercial real estate, which consists of construction and land development loans and real estate loans. Approximately 11% of the Company's loans were residential mortgage loans. Approximately 2% of the Company's loans were residential construction loans. Approximately 13% of the Company's loans were for agriculture and 18% of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 15% of the Company's loans were consumer loans.

Once a loan becomes delinquent and repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment in full is unlikely, the Company will estimate its probable loss, using a recent valuation as appropriate to the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final collection, the Company may periodically revalue the underlying collateral and take additional charge-offs as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when collateral is liquidated and actual loss is known. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

All loans at September 30, 2011 and December 31, 2010 were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank and Federal Reserve.

Non-accrual and Past Due Loans

The Company's non-accrual loans by loan class, as of September 30, 2011 and December 31, 2010 were as follows:

($ in thousands)	September 30, 2011	December 31, 2010
Commercial	$177	$1,817
Commercial Real Estate	2,729	5,864
Agriculture	—	1,752
Residential Mortgage	1,044	2,301
Residential Construction	305	272
Consumer	296	268
	$4,551	$12,274

Non-accrual loans amounted to $4,551,000 at September 30, 2011 and were comprised of three residential mortgage loans totaling $1,044,000, two residential construction loans totaling $305,000, six commercial real estate loans totaling $2,729,000, four commercial loans totaling $177,000 and five consumer loans totaling $296,000. Non-accrual loans amounted to $12,274,000 at December 31, 2010 and were comprised of seven residential mortgage loans totaling $2,301,000, four residential construction loans totaling $272,000, nine commercial real estate loans totaling $5,864,000, one agricultural loan totaling $1,752,000, ten commercial loans totaling $1,817,000 and five consumer loans totaling $268,000. 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 the estimated net realizable value of the underlying collateral.

An age analysis of past due loans, segregated by loan class, as of September 30, 2011 and December 31, 2010 is as follows:

($ in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans
September 30, 2011						
Commercial	$1,377	$1,463	$133	$2,973	$78,482	$81,455
Commercial Real Estate	1,063	2,301	1,791	5,155	172,998	178,153
Agriculture	—	—	—	—	55,762	55,762
Residential Mortgage	277	—	470	747	49,492	50,239
Residential Construction	42	—	258	300	7,826	8,126
Consumer	211	2	296	509	65,049	65,558
Total	$2,970	$3,766	$2,948	$9,684	$429,609	$439,293
December 31, 2010						
Commercial	$1,606	$193	$228	$2,027	$80,788	$82,815
Commercial Real Estate	1,270	1,974	3,767	7,011	179,394	186,405
Agriculture	—	—	1,751	1,751	51,289	53,040
Residential Mortgage	749	—	1,326	2,075	50,272	52,347
Residential Construction	462	—	63	525	9,721	10,246
Consumer	421	88	242	751	67,623	68,374
Total	$4,508	$2,255	$7,377	$14,140	$439,087	$453,227

The Company had one loan with a balance of $349,000 that was 90 days or more past due and still accruing at September 30, 2011 and no loans 90 days or more past due and still accruing at December 31, 2010.

Impaired Loans

Impaired loans, segregated by loan class, as of September 30, 2011 and December 31, 2010 were as follows:

($ in thousands)	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
September 30, 2011					
Commercial	$ 3,486	$ 1,923	$ 1,555	$ 3,478	$ 73
Commercial Real Estate	7,557	2,729	4,828	7,557	633
Agriculture	280	280	—	280	—
Residential Mortgage	5,382	1,044	4,115	5,159	898
Residential Construction	1,539	332	1,105	1,437	643
Consumer	727	296	295	591	121
Total	$ 18,971	$ 6,604	$ 11,898	$ 18,502	$ 2,368
December 31, 2010					
Commercial	$ 3,725	$ 1,660	$ 1,334	$ 2,994	$ 89
Commercial Real Estate	7,414	5,864	1,224	7,088	22
Agriculture	2,785	1,752	383	2,135	41
Residential Mortgage	6,544	2,123	3,910	6,033	543
Residential Construction	2,058	272	1,349	1,621	575
Consumer	312	258	36	294	12
Total	$ 22,838	$ 11,929	$ 8,236	$ 20,165	$ 1,282

Interest income on impaired loans recognized using a cash-basis method of accounting during the three-month periods ended September 30, 2011 and 2010 was as follows:

($ in thousands)	Three Months Ended September 30, 2011		Three Months Ended September 30, 2010	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$ 3,619	$ 62	$ 1,565	$ 79
Commercial Real Estate	9,880	78	8,799	33
Agriculture	1,062	2	2,997	5
Residential Mortgage	5,455	64	5,515	45
Residential Construction	1,416	14	2,680	13
Consumer	446	1	319	—
Total	$ 21,878	$ 221	$ 21,875	$ 175

Interest income on impaired loans recognized using a cash-basis method of accounting during the nine-month periods ended September 30, 2011 and 2010 was as follows:

($ in thousands)	Nine Months Ended September 30, 2011		Nine Months Ended September 30, 2010	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$3,242	$ 102	$2,899	$ 130
Commercial Real Estate	8,455	378	8,887	177
Agriculture	1,597	6	3,195	16
Residential Mortgage	5,834	152	5,519	180
Residential Construction	1,611	54	3,617	45
Consumer	402	5	259	—
Total	$21,141	$ 697	$24,376	$ 548

Troubled Debt Restructurings

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

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

As a result of adopting the amendments in ASU 2011-02, discussed in Note 1, management reassessed all restructuring that occurred on or after January 1, 2011 for identification as TDRs. Management identified as TDRs for which the allowance for loan losses associated had previously been measured under a general allowance for loan losses methodology. Upon identifying those receivables as TDRs, they are newly considered as impaired under the guidance in the Accounting Standards Codification (ASC) Section 310-10-35. The amendments in ASU 2011-02 require prospective application of the impairment guidance in ASC Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption (September 30, 2011), the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance for loan losses methodology and now considered impaired was $692,000, and their related specific allowance, based on a current evaluation of loss, was $130,000.

The Company had $9,757,000 and $10,259,000 TDR loans as of September 30, 2011 and December 31, 2010, respectively. TDR loans performing in compliance with modified terms totaled $8,260,000 and $7,891,000 as of September 30, 2011 and December 21, 2010, respectively.

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

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

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

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

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. There were no troubled debt restructurings modified within the previous 12 months and for which there was a payment default during the three-month period ended September 30, 2011. There was one consumer loan with a recorded investment of $25,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the nine-month period ended September 30, 2011.

Credit Quality Indicators

All new loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and 8 equates to a Loss. General definitions for each risk rating are as follows:

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

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

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

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

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

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

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

Risk Rating "8" – Loss (Classified):

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

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

The following table presents the risk ratings by loan class as of September 30, 2011 and December 31, 2010.

($ in thousands)	Pass	Special Mention	Substandard	Doubtful	Loss	Total
September 30, 2011						
Commercial	$60,276	$5,978	$14,525	$630	$46	$81,455
Commercial Real Estate	151,834	10,943	15,376	—	—	178,153
Agriculture	47,689	2,745	5,328	—	—	55,762
Residential Mortgage	41,740	593	7,906	—	—	50,239
Residential Construction	5,464	575	2,087	—	—	8,126
Consumer	59,091	1,884	4,583	—	—	65,558
Total	$366,094	$22,718	$49,805	$630	$46	$439,293
December 31, 2010						
Commercial	$57,966	$7,764	$15,862	$1,146	$77	$82,815
Commercial Real Estate	147,350	26,040	13,015	—	—	186,405
Agriculture	43,384	4,991	4,665	—	—	53,040
Residential Mortgage	41,437	3,235	7,675	—	—	52,347
Residential Construction	5,890	2,315	2,041	—	—	10,246
Consumer	59,824	4,617	3,933	—	—	68,374
Total	$355,851	$48,962	$47,191	$1,146	$77	$453,227

Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2011.

Three-month period ended September 30, 2011

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

Nine-month period ended September 30, 2011

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of December 31, 2010	$ 3,761	$ 1,957	$ 2,141	$ 830	$ 1,719	$ 556	$ 75	$ 11,039
Provision for loan losses	399	1,283	1,023	645	(346)	638	28	3,670
Charge-offs	(911)	(1,414)	(610)	(228)	(198)	(681)	—	(4,042)
Recoveries	141	275	140	11	53	150	—	770
Net charge-offs	(770)	(1,139)	(470)	(217)	(145)	(531)	—	(3,272)
Balance as of September 30, 2011	3,390	2,101	2,694	1,258	1,228	663	103	11,437

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2011.

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

Loans collectively evaluated for impairment								
Ending Balance	$ 3,390	$ 2,101	$ 2,694	$ 1,258	$ 1,228	$ 663	$ 103	$ 11,437

The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2010.

Three-month period ended September 30, 2010

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of June 30, 2010	$ 4,279	$ 2,319	$ 1,922	$ 765	$ 1,417	$ 715	$ 613	$ 12,030
Provision for loan losses	301	178	110	412	365	225	(601)	990
Charge-offs	(104)	—	(1)	(311)	(375)	(316)	—	(1,107)
Recoveries	82	—	360	—	—	49	—	491
Net charge-offs	(22)	—	359	(311)	(375)	(267)	—	(616)
Balance as of September 30, 2010	4,558	2,497	2,391	866	1,407	673	12	12,404

Nine-month period ended September 30, 2010

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of December 31, 2009	$ 4,036	$ 2,706	$ 1,681	$ 735	$ 1,611	$ 506	$ 641	$ 11,916
Provision for loan losses	947	16	718	846	521	884	(629)	3,303
Charge-offs	(941)	(227)	(368)	(715)	(731)	(861)	—	(3,843)
Recoveries	516	2	360	—	6	144	—	1,028
Net charge-offs	(425)	(225)	(8)	(715)	(725)	(717)	—	(2,815)
Balance as of September 30, 2010	4,558	2,497	2,391	866	1,407	673	12	12,404

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2010.

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Period-end amount allocated to:								
Loans individually evaluated for impairment	12	166	548	473	360	6	—	1,565
Loans collectively evaluated for impairment	4,546	2,331	1,843	393	1,047	667	12	10,839

Ending Balance	$ 4,558	$ 2,497	$ 2,391	$ 866	$ 1,407	$ 673	$ 12	$ 12,404

The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the period ended December 31, 2010.

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Beginning balance	$ 4,036	$ 2,706	$ 1,681	$ 735	$ 1,611	$ 506	$ 641	$ 11,916
Provision for loan losses	1,115	741	1,118	788	932	786	(566)	4,914
Charge-offs	(1,930)	(1,491)	(736)	(715)	(830)	(914)	—	(6,616)
Recoveries	540	1	78	22	6	178	—	825
Net charge-offs	(1,390)	(1,490)	(658)	(693)	(824)	(736)	—	(5,791)
Ending Balance	3,761	1,957	2,141	830	1,719	556	75	11,039
Period-end amount allocated to:								
Loans individually evaluated for impairment	89	22	41	543	575	12	—	1,282
Loans collectively evaluated for impairment	3,672	1,935	2,100	287	1,144	544	75	9,757
Ending Balance	$ 3,761	$ 1,957	$ 2,141	$ 830	$ 1,719	$ 556	$ 75	$ 11,039

The Company's investment in loans as of September 30, 2011, September 30, 2010, and December 31, 2010 related to each balance in the allowance for loan losses by loan class and disaggregated on the basis of the Company's impairment methodology was as follows:

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Total
September 30, 2011							
Loans individually evaluated for impairment	$ 3,478	$ 7,557	$ 280	$ 5,159	$ 1,437	$ 591	$ 18,502
Loans collectively evaluated for impairment	77,977	170,596	55,482	45,080	6,689	64,967	420,791
Ending Balance	$ 81,455	$ 178,153	$ 55,762	$ 50,239	$ 8,126	$ 65,558	$ 439,293
September 30, 2010							
Loans individually evaluated for impairment	$ 1,455	$ 8,885	$ 2,787	$ 5,796	$ 2,089	$ 274	$ 21,286
Loans collectively evaluated for	86,548	180,040	53,180	46,841	8,258	67,596	442,463

impairment							
Ending Balance	$ 88,003	$ 188,925	$ 55,967	$ 52,637	$ 10,347	$ 67,870	$ 463,749
December 31, 2010							
Loans individually evaluated for impairment	$ 2,994	$ 7,088	$ 2,135	$ 6,033	$ 1,621	$ 294	$ 20,165
Loans collectively evaluated for impairment	79,821	179,317	50,905	46,314	8,625	68,080	433,062
Ending Balance	$ 82,815	$ 186,405	$ 53,040	$ 52,347	$ 10,246	$ 68,374	$ 453,227

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, 2011 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, 2011, the Company had $3,419,000 of mortgage loans held-for-sale. At September 30, 2011 and December 31, 2010, the Company serviced real estate mortgage loans for others of $208,837,000 and $211,124,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2011 and December 31, 2010.

	(in thousands)			
	December 31, 2010	Additions	Reductions	September 30, 2011
Mortgage servicing rights	$1,712	$174	$285	$1,601
Valuation allowance	(345)	—	(104)	(241)
Mortgage servicing rights, net of valuation allowance	$1,367	$174	$181	$1,360

4. OUTSTANDING SHARES AND EARNINGS PER SHARE

Earnings Per Share (EPS)

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

The following table presents a reconciliation of basic and diluted EPS for the three-month and nine-month periods ended September 30, 2011 and 2010.

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Basic earnings per share:				
Net income	$948	$757	$2,509	$1,717
Preferred stock dividend and accretion	$(607)	$(248)	$(1,107)	$(743)
Net income available to common shareholders	$341	$509	$1,402	$974
Weighted average common shares outstanding	9,070,746	9,019,320	9,066,360	9,016,214
Basic EPS	$0.04	$0.06	$0.15	$0.11
Diluted earnings per share:				
Net income	$948	$757	$2,509	$1,717
Preferred stock dividend and accretion	$(607)	$(248)	$(1,107)	$(743)
Net income available to common shareholders	$341	$509	$1,402	$974
Weighted average common shares outstanding	9,070,746	9,019,320	9,066,360	9,016,214
Effect of dilutive options	9	441	1,149	1,730
Adjusted weighted average common shares outstanding	9,070,755	9,019,761	9,067,509	9,017,944
Diluted EPS	$0.04	$0.06	$0.15	$0.11

Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 417,490 and 507,109 for the three months ended September 30, 2011 and 2010 respectively. In addition, warrants for 352,977 shares issued to the U.S. Treasury were not used in the computation of diluted earnings per share for both periods because they would have had an anti-dilutive effect.

Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 424,742 and 499,492 for the nine months ended September 30, 2011 and 2010 respectively. In addition, warrants for 352,977 shares issued to the U.S. Treasury were not used in the computation of diluted earnings per share for both periods because they would have had an anti-dilutive effect.

5. &#