

FIRST NORTHERN COMMUNITY BANCORP  
Form 10-Q  
November 01, 2017  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2017

OR

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

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

Commission File Number 000-30707

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

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

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.  
Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company  
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

The number of shares of Common Stock outstanding as of October 27, 2017 was 11,172,640.

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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 (UNAUDITED)

| (in thousands, except share amounts)   | September<br>30, 2017 | December<br>31, 2016 |
|--|-----------------------|----------------------|
| Assets   |                       |                      |
| Cash and cash equivalents  | \$ 150,156            | \$ 159,643           |
| Certificates of deposit  | 3,968                 | 16,213               |
| Investment securities – available-for-sale   | 302,255               | 277,079              |
| Loans, net of allowance for loan losses of \$11,563 at September 30, 2017 and \$10,899 at December 31, 2016  | 693,066               | 669,770              |
| Loans held-for-sale  | 1,811                 | 3,326                |
| Stock in Federal Home Loan Bank and other equity securities, at cost   | 5,567                 | 4,409                |
| Premises and equipment, net  | 6,383                 | 7,304                |
| Interest receivable and other assets   | 29,644                | 29,019               |
| <b>Total Assets</b>  | <b>\$ 1,192,850</b>   | <b>\$ 1,166,763</b>  |
| Liabilities and Stockholders' Equity   |                       |                      |
| Liabilities:   |                       |                      |
| Demand deposits  | \$ 361,969            | \$ 362,688           |
| Interest-bearing transaction deposits  | 303,075               | 293,343              |
| Savings and MMDA's   | 338,220               | 331,730              |
| Time, \$250,000 or less  | 57,554                | 60,677               |
| Time, over \$250,000   | 20,014                | 15,258               |
| Total deposits   | 1,080,832             | 1,063,696            |
| Interest payable and other liabilities   | 11,374                | 10,769               |
| <b>Total Liabilities</b>   | <b>1,092,206</b>      | <b>1,074,465</b>     |
| Stockholders' Equity:  |                       |                      |
| Common stock, no par value; 16,000,000 shares authorized; 11,172,640 shares issued and outstanding at September 30, 2017 and 11,148,446 shares issued and outstanding at December 31, 2016 | 79,574                | 79,114               |
| Additional paid-in capital   | 977                   | 977                  |
| Retained earnings  | 22,201                | 14,557               |
| Accumulated other comprehensive loss, net  | (2,108 )              | (2,350 )             |
| <b>Total Stockholders' Equity</b>  | <b>100,644</b>        | <b>92,298</b>        |
| <b>Total Liabilities and Stockholders' Equity</b>  | <b>\$ 1,192,850</b>   | <b>\$ 1,166,763</b>  |

See notes to unaudited condensed consolidated financial statements.

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## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

|  | Three<br>months<br>ended<br>September<br>30, 2017 | Three<br>months<br>ended<br>September<br>30, 2016 | Nine<br>months<br>ended<br>September<br>30, 2017 | Nine<br>months<br>ended<br>September<br>30, 2016 |
|--|---|---|--|--|
| (in thousands, except per share amounts)                       |   |   |  |  |
| Interest and dividend income:                                  |   |   |  |  |
| Loans  | \$ 8,394  | \$ 7,771  | \$ 24,566  | \$ 22,802  |
| Due from banks interest bearing accounts                       | 419   | 215   | 1,042  | 676  |
| Investment securities  |   |   |  |  |
| Taxable  | 1,252   | 913   | 3,545  | 2,577  |
| Non-taxable  | 61  | 66  | 209  | 202  |
| Other earning assets   | 93  | 97  | 284  | 274  |
| Total interest and dividend income                             | 10,219  | 9,062   | 29,646   | 26,531   |
| Interest expense:  |   |   |  |  |
| Deposits   | 272   | 289   | 792  | 848  |
| Total interest expense   | 272   | 289   | 792  | 848  |
| Net interest income  | 9,947   | 8,773   | 28,854   | 25,683   |
| Provision for loan losses                                      | —   | 450   | 600  | 1,350  |
| Net interest income after provision for loan losses            | 9,947   | 8,323   | 28,254   | 24,333   |
| Non-interest income:   |   |   |  |  |
| Service charges on deposit accounts                            | 532   | 510   | 1,445  | 1,536  |
| Gains on sales of other real estate owned                      | —   | —   | —  | 4  |
| Gains on sales of loans held-for-sale                          | 123   | 234   | 418  | 596  |
| Investment and brokerage services income                       | 157   | 139   | 445  | 401  |
| Mortgage brokerage income                                      | 32  | 9   | 75   | 31   |
| Loan servicing income  | 98  | (49)  | 364  | 171  |
| Fiduciary activities income                                    | 122   | 108   | 365  | 326  |
| Debit card income  | 508   | 499   | 1,476  | 1,467  |
| Gains (losses) on sales/calls of available-for-sale securities | 2   | (21)  | (14)   | (7)  |
| Gain on sale-leaseback of real estate                          | —   | —   | 1,187  | —  |
| Other income   | 206   | 228   | 619  | 672  |
| Total non-interest income                                      | 1,780   | 1,657   | 6,380  | 5,197  |
| Non-interest expenses:   |   |   |  |  |
| Salaries and employee benefits                                 | 4,445   | 4,039   | 13,649   | 12,323   |
| Occupancy and equipment  | 747   | 758   | 2,136  | 2,247  |
| Data processing  | 430   | 421   | 1,269  | 1,180  |
| Stationery and supplies  | 85  | 91  | 263  | 275  |
| Advertising  | 80  | 90  | 226  | 233  |
| Directors' fees  | 86  | 77  | 221  | 212  |
| Other real estate owned expense                                | 4   | —   | 3  | 1  |
| Other expense  | 1,284   | 1,123   | 4,117  | 3,755  |
| Total non-interest expenses                                    | 7,161   | 6,599   | 21,884   | 20,226   |
| Income before provision for income taxes                       | 4,566   | 3,381   | 12,750   | 9,304  |
| Provision for income taxes                                     | 1,766   | 1,362   | 4,889  | 3,519  |
| Net income   | \$ 2,800  | \$ 2,019  | \$ 7,861   | \$ 5,785   |

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|                                   |         |         |         |         |
|-----------------------------------|---------|---------|---------|---------|
| Basic earnings per common share   | \$ 0.25 | \$ 0.18 | \$ 0.71 | \$ 0.52 |
| Diluted earnings per common share | \$ 0.25 | \$ 0.18 | \$ 0.70 | \$ 0.52 |

See notes to unaudited condensed consolidated financial statements.

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## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

|   | Three<br>months<br>ended<br>September<br>30, 2017 | Three<br>months<br>ended<br>September<br>30, 2016 | Nine<br>months<br>ended<br>September<br>30, 2017 | Nine<br>months<br>ended<br>September<br>30, 2016 |
|---|---|---|--|--|
| (in thousands)  |   |   |  |  |
| Net income  | \$ 2,800  | \$ 2,019  | \$ 7,861   | \$ 5,785   |
| Other comprehensive income (loss), net of tax:  |   |   |  |  |
| Unrealized holding gains arising during the period, net of tax effect of \$116 and \$(265) for the three months ended September 30, 2017 and September 30, 2016, respectively, and \$186 and \$347 for the nine months ended September 30, 2017 and September 30, 2016, respectively                              | 176   | (401 )  | 280  | 519  |
| Less: reclassification adjustment due to (gains) losses realized on sales of securities, net of tax effect of \$(1) and \$8 for the three months ended September 30, 2017 and September 30, 2016, respectively, and \$6 and \$3 for the nine months ended September 30, 2017 and September 30, 2016, respectively | (1 )  | 13  | 8  | 4  |
| Directors' and officers' retirement plan equity adjustments, net of tax effect of \$0 for the three months ended September 30, 2017 and September 30, 2016, and \$(31) and \$0 for the nine months ended September 30, 2017 and September 30, 2016, respectively  | —   | —   | (46 )  | —  |
| Other comprehensive income (loss), net of tax   | \$ 175  | \$ (388 )   | \$ 242   | \$ 523   |
| Comprehensive income  | \$ 2,975  | \$ 1,631  | \$ 8,103   | \$ 6,308   |

See notes to unaudited condensed consolidated financial statements.



## FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except share data)

|  | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss |   | Total     |
|--|--------------|----------|----------------------------------|----------------------|---|---|-----------|
|  | Shares       | Amounts  |                                  |                      |   |   |           |
| Balance at December 31, 2015   | 10,676,557   | \$73,764 | \$ 977                           | \$11,603             | \$ (495                                       | ) | \$85,849  |
| Net income   |              |          |                                  | 8,051                |   |   | 8,051     |
| Other comprehensive loss, net of taxes   |              |          |                                  |                      | (1,855  | ) | (1,855 )  |
| Stock dividend adjustment  | 505          | 4        |                                  | (4 )                 |   |   | —         |
| 4% stock dividend declared in 2017   | 428,786      | 5,088    |                                  | (5,088 )             |   |   | —         |
| Cash in lieu of fractional shares  | (101 )       |          |                                  | (5 )                 |   |   | (5 )      |
| Stock-based compensation   |              | 286      |                                  |                      |   |   | 286       |
| Tax deficiency related to expired, vested non-qualified stock options                      |              | (114 )   |                                  |                      |   |   | (114 )    |
| Common shares issued related to restricted stock grants                                    | 34,976       | 61       |                                  |                      |   |   | 61        |
| Stock options exercised  | 7,723        | 25       |                                  |                      |   |   | 25        |
| Balance at December 31, 2016   | 11,148,446   | \$79,114 | \$ 977                           | \$14,557             | \$ (2,350                                     | ) | \$92,298  |
| Net income   |              |          |                                  | 7,861                |   |   | 7,861     |
| Other comprehensive income, net of taxes   |              |          |                                  |                      | 242   |   | 242       |
| Stock dividend adjustment  | 289          | 207      |                                  | (207 )               |   |   | —         |
| Cash in lieu of fractional shares  | (129 )       |          |                                  | (10 )                |   |   | (10 )     |
| Stock-based compensation   |              | 253      |                                  |                      |   |   | 253       |
| Common shares issued related to restricted stock grants, net of restricted stock reversals | 24,034       | —        |                                  |                      |   |   | —         |
| Balance at September 30, 2017  | 11,172,640   | \$79,574 | \$ 977                           | \$22,201             | \$ (2,108                                     | ) | \$100,644 |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

|  | (in thousands)                                   |  |
|--|--|--|
|  | Nine<br>months<br>ended<br>September<br>30, 2017 | Nine<br>months<br>ended<br>September<br>30, 2016 |
| <b>Cash Flows From Operating Activities</b>  |  |  |
| Net income   | \$7,861  | \$ 5,785   |
| Adjustments to reconcile net income to net cash provided by operating activities:    |  |  |
| Depreciation   | 449  | 469  |
| Accretion and amortization of investment securities premiums and discounts, net      | 2,751  | 2,197  |
| Valuation adjustment on mortgage servicing rights                                    | (21 )  | 169  |
| Increase in deferred loan origination fees and costs, net                            | 237  | 14   |
| Provision for loan losses  | 600  | 1,350  |
| Stock-based compensation   | 253  | 208  |
| Losses (gain) on sales/calls of available-for-sale securities                        | 14   | 7  |
| Gain on sale-leaseback of real estate  | (1,187 )   | —  |
| Gains on sales of other real estate owned  | —  | (4 )   |
| Gains on sales of loans held-for-sale  | (418 )   | (596 )   |
| Proceeds from sales of loans held-for-sale   | 21,823   | 28,423   |
| Originations of loans held-for-sale  | (19,890 )  | (29,668 )  |
| Changes in assets and liabilities:   |  |  |
| Increase in interest receivable and other assets                                     | (765 )   | (1,283 )   |
| Increase (decrease) in interest payable and other liabilities                        | 528  | (429 )   |
| Net cash provided by operating activities  | 12,235   | 6,642  |
| <b>Cash Flows From Investing Activities</b>  |  |  |
| Proceeds from calls or maturities of available-for-sale securities                   | 8,075  | 31,464   |
| Proceeds from sales of available-for-sale securities                                 | 462  | 756  |
| Principal repayments on available-for-sale securities                                | 37,130   | 25,409   |
| Purchase of available-for-sale securities  | (73,128 )  | (133,414 )                                       |
| Net decrease (increase) in certificates of deposit                                   | 12,245   | (60 )  |
| Net increase in loans  | (24,133 )  | (39,974 )  |
| Net increase in stock in Federal Home Loan Bank and other equity securities, at cost | (1,158 )   | (475 )   |
| Proceeds from sale of other real estate owned  | —  | 221  |
| Proceeds from sale of bank premises and equipment                                    | 2,868  | —  |
| Purchases of bank premises and equipment, net  | (1,209 )   | (888 )   |
| Net cash used in investing activities  | (38,848 )  | (116,961 )                                       |
| <b>Cash Flows From Financing Activities</b>  |  |  |
| Net increase in deposits   | 17,136   | 68,411   |
| Cash dividends paid in lieu of fractional shares                                     | (10 )  | (5 )   |
| Stock options exercised  | —  | 25   |
| Net cash provided by financing activities  | 17,126   | 68,431   |
| Net decrease in Cash and Cash Equivalents  | (9,487 )   | (41,888 )  |
| Cash and Cash Equivalents, beginning of period                                       | 159,643  | 200,797  |

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|  |           |           |
|--|-----------|-----------|
| Cash and Cash Equivalents, end of period   | \$150,156 | \$158,909 |
| Supplemental Disclosures of Cash Flow Information:   |           |           |
| Cash paid during the period for:   |           |           |
| Interest   | \$775     | \$819     |
| Income taxes   | \$5,115   | \$3,940   |
| Supplemental disclosures of non-cash investing and financing activities:                   |           |           |
| Stock dividend distributed   | \$5,295   | \$3,351   |
| Transfer of loans held-for-investment to other real estate owned                           | \$—       | \$217     |
| Decrease in directors' & officers' retirement plan equity adjustment, net of tax           | \$(46     | ) \$—     |
| Change in unrealized holding gains (losses) on available for sale securities, net of taxes | \$288     | \$523     |
| See notes to unaudited condensed consolidated financial statements.                        |           |           |

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FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2017 and 2016 and December 31, 2016

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 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, 2016 as filed with the Securities and Exchange Commission. The preparation of financial statements in conformity with GAAP 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 as well as 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.

2. ACCOUNTING POLICIES

The most significant accounting policies followed by the Company are presented in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, Management has identified the allowance for loan losses accounting to be the accounting area requiring the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available. A discussion of the factors affecting accounting for the allowance for loan losses is included in the "Asset Quality" and "Allowance for Loan Loss" discussions below. Certain amounts in prior periods have been reclassified to conform to the current presentation.

Application of these principles requires the Company to make certain estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain accounting policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment writedown or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

Recently Issued Accounting Pronouncements:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. ASU 2014-09 was initially effective for the Company's reporting period beginning on January 1, 2017. However, in August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers - Deferral of the Effective Date, which defers the effective date by one year. For financial reporting purposes, the standard allows for either a full retrospective or modified retrospective adoption. The FASB has also issued additional updates to provide further clarification to specific implementation issues associated with ASU 2014-09. These updates include ASU 2016-08, Principal versus Agent Considerations, ASU 2016-10, Identifying Performance Obligations and Licensing, ASU 2016-12, Narrow-Scope Improvements and Practical Expedients, and ASU 2016-20, Technical Corrections and Improvements to Topic 606. Our revenue is comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and non-interest income. We expect that ASU 2014-09 will require us to change how we recognize certain recurring revenue streams; however, we do not expect these changes to have a material impact on non-interest income. We are finalizing the adoption of ASU 2014-09 and do not expect a material impact on our financial statements. We expect to adopt the standard beginning January 1, 2018 under the modified retrospective approach with a cumulative effect adjustment to opening retained earnings, if such adjustment is deemed to be significant.

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In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The amendments in ASU 2016-02, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and

A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

The amendments in this ASU are effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The Company currently leases ten properties. The effect to the Company's financial statements will be a recordation of a lease liability and a right-of-use asset. Management has not yet quantified the lease liability and right-of-use asset and is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In June 2016, FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments in ASU 2016-13, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments are effective for public companies for annual periods beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Management is currently gathering data required to measure expected credit losses in accordance with this ASU, and will then evaluate the impact of this ASU on the Company's consolidated financial statements. While the Company has not quantified the impact of this ASU, it does expect changing from the current loss model to an expected loss model to result in an earlier recognition of losses.

In January 2017, FASB issued ASU 2017-01, Business Combinations (Topic 805) - Clarifying the Definition of a Business. The amendments in ASU 2017-01 clarify the definition and provide a more robust framework to use in determining when a set of assets and activities constitutes a business. ASU 2017-01 is intended to provide guidance when evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendments are effective for public companies for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In January 2017, FASB issued ASU 2017-03, Accounting Changes and Error Corrections (Topic 250) and Investments - Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings. These amendments apply to ASU 2014-9 (Revenue from Contracts with Customers), ASU 2016-02 (Leases), and ASU 2016-13 (Financial Instruments - Credit Losses).

In March 2017, FASB issued ASU 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments also allow only the service cost component to be eligible for capitalization when applicable. The amendments are effective for public companies for annual periods

beginning after December 15, 2017, including interim periods within those periods. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In March 2017, FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities. The amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments are effective for public companies for annual periods beginning after December 15, 2018, including interim periods within those annual periods. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In May 2017, FASB issued ASU 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for public companies for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In July 2017, FASB issued ASU 2017-11, Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception. These amendments simplify the accounting for certain financial instruments with down round features. The amendments are effective for public companies for annual periods beginning after December 15, 2018, including interim periods within those annual periods. The Company currently does not have any financial instruments with down round features and therefore does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

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## 3. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2017 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|---------------------|----------------------|-------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                         |
| U.S. Treasury Securities                                | \$ 28,621         | \$ —                | \$ (81 )             | \$ 28,540               |
| Securities of U.S. government agencies and corporations | 22,363            | 3                   | (142 )               | 22,224                  |
| Obligations of states and political subdivisions        | 24,438            | 275                 | (88 )                | 24,625                  |
| Collateralized mortgage obligations                     | 71,385            | 2                   | (1,011 )             | 70,376                  |
| Mortgage-backed securities                              | 157,764           | 209                 | (1,483 )             | 156,490                 |
| Total debt securities                                   | \$ 304,571        | \$ 489              | \$ (2,805 )          | \$ 302,255              |

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2016 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>fair<br>value |
|---|-------------------|---------------------|----------------------|----------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                            |
| U.S. Treasury Securities                                | \$ 28,738         | \$ 2                | \$ (88 )             | \$ 28,652                  |
| Securities of U.S. government agencies and corporations | 24,382            | 2                   | (187 )               | 24,197                     |
| Obligations of states and political subdivisions        | 30,870            | 271                 | (253 )               | 30,888                     |
| Collateralized mortgage obligations                     | 51,002            | 1                   | (1,065 )             | 49,938                     |
| Mortgage-backed securities                              | 144,883           | 280                 | (1,759 )             | 143,404                    |
| Total debt securities                                   | \$ 279,875        | \$ 556              | \$ (3,352 )          | \$ 277,079                 |

The Company had \$5,800,000 and \$8,537,000 in proceeds from sales/calls of available-for-sale securities for the three and nine months ended September 30, 2017, respectively. The Company had \$10,760,000 and \$31,464,000 in proceeds from sales/calls of available-for-sale securities for the three and nine months ended September 30, 2016. Gross realized gains on sales of available-for-sale securities were \$2,000 for the three and nine months ended September 30, 2017. Gross realized gains from sales of available-for-sale securities were \$1,000 and \$15,000 for the three and nine months ended September 30, 2016, respectively. Gross realized losses from sales/calls of available-for-sale securities were \$0 and \$(16,000) for the three and nine months ended September 30, 2017, respectively. Gross realized losses on sales/calls of available-for-sale securities were \$(22,000) for the three and nine months ended September 30, 2016.

The amortized cost and estimated market value of debt and other securities at September 30, 2017, by contractual and expected maturity, are shown in the following table:

| (in thousands) | Amortized<br>cost | Estimated<br>fair value |
|----------------|-------------------|-------------------------|
|----------------|-------------------|-------------------------|

Maturity in years:

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|  |            |            |
|--|------------|------------|
| Due in one year or less                | \$ 28,811  | \$ 28,792  |
| Due after one year through five years  | 41,325     | 41,114     |
| Due after five years through ten years | 5,286      | 5,483      |
| Due after ten years                    | —          | —          |
| Subtotal                               | 75,422     | 75,389     |
| MBS & CMO                              | 229,149    | 226,866    |
| Total                                  | \$ 304,571 | \$ 302,255 |

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. In addition, factors such as prepayments and interest rates may affect the yield on the carrying value of mortgage-related securities.

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An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of September 30, 2017, follows:

| (in thousands)  | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized losses | Fair Value        | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Treasury securities                                | \$28,539            | \$ (81 )          | \$—               | \$ —              | \$28,539   | \$ (81 )          |
| Securities of U.S. government agencies and corporations | 20,221              | (142 )            | —                 | —                 | 20,221     | (142 )            |
| Obligations of states and political subdivisions        | 12,051              | (80 )             | 2,668             | (8 )              | 14,719     | (88 )             |
| Collateralized Mortgage obligations                     | 60,649              | (865 )            | 7,216             | (146 )            | 67,865     | (1,011 )          |
| Mortgage-backed securities                              | 88,329              | (722 )            | 40,835            | (761 )            | 129,164    | (1,483 )          |
| Total   | \$209,789           | \$ (1,890 )       | \$50,719          | \$ (915 )         | \$260,508  | \$ (2,805 )       |

No decline in value was considered "other-than-temporary" during the first nine months of 2017. One hundred fifty securities, all considered investment grade, which had a fair value of \$209,789,000 and a total unrealized loss of \$1,890,000, have been in an unrealized loss position for less than twelve months as of September 30, 2017. Thirty nine securities, all considered investment grade, which had a fair value of \$50,719,000 and a total unrealized loss of \$915,000, have been in an unrealized loss position for more than twelve months as of September 30, 2017. The declines in fair value were attributable to changes in interest rates. We have evaluated the credit ratings of our investment securities and their issuer and/or insurers, and based on this evaluation have determined that no investment security in our investment portfolio was other-than-temporarily impaired as of September 30, 2017. As the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities prior to their anticipated recovery, these investments are not considered other-than-temporarily impaired.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2016, follows:

|   | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized losses | Fair Value        | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Treasury Securities                                | \$23,564            | \$ (88 )          | \$—               | \$ —              | \$23,564   | \$ (88 )          |
| Securities of U.S. government agencies and corporations | 22,195              | (187 )            | —                 | —                 | 22,195     | (187 )            |
| Obligations of states and political subdivisions        | 16,168              | (245 )            | 996               | (8 )              | 17,164     | (253 )            |
| Collateralized Mortgage obligations                     | 49,805              | (1,065 )          | —                 | —                 | 49,805     | (1,065 )          |
| Mortgage-backed securities                              | 109,092             | (1,678 )          | 4,829             | (81 )             | 113,921    | (1,759 )          |
| Total   | \$220,824           | \$ (3,263 )       | \$5,825           | \$ (89 )          | \$226,649  | \$ (3,352 )       |

Investment securities carried at \$34,428,000 and \$38,152,000 at September 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

## 4. LOANS

The composition of the Company's loan portfolio, by loan class, as of September 30, 2017 and December 31, 2016 was as follows:

| (\$ in thousands)                       | September<br>30, 2017 | December<br>31, 2016 |
|---|-----------------------|----------------------|
| Commercial                              | \$ 123,656            | \$ 126,311           |
| Commercial Real Estate                  | 366,350               | 344,210              |
| Agriculture                             | 109,140               | 101,905              |
| Residential Mortgage                    | 42,844                | 40,237               |
| Residential Construction                | 21,969                | 23,650               |
| Consumer                                | 39,801                | 43,250               |
|   | 703,760               | 679,563              |
| Allowance for loan losses               | (11,563 )             | (10,899 )            |
| Net deferred origination fees and costs | 869                   | 1,106                |
| Loans, net                              | \$ 693,066            | \$ 669,770           |

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

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and 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.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner-occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to Commercial loans whether secured by equipment, receivables or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and

related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or 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 such as drought or floods. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary.

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

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.

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.

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 annually but may be more frequent depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

As of September 30, 2017, approximately 52% in principal amount of the Company's loans were secured by commercial real estate, consisting primarily of loans secured by commercial properties and construction and land development loans. Approximately 6% in principal amount of the Company's loans were residential mortgage loans. Approximately 3% in principal amount of the Company's loans were residential construction loans. Approximately 15% in principal amount of the Company's loans were for agriculture and 18% in principal amount of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 6% in principal amount of the Company's loans were consumer loans.

Once a loan becomes delinquent and repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment of principal and interest in accordance with the contractual terms of the loan agreement becomes unlikely, the Company will consider the loan to be impaired and will estimate its probable loss, using the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. For collateral dependent loans, the Company will obtain an updated valuation of 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 estimated loss and take additional charge-offs or specific reserves 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 the collateral is liquidated and the actual loss is confirmed. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

At September 30, 2017 and December 31, 2016, all loans were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank ("FHLB") and the Federal Reserve Bank.

Non-accrual and Past Due Loans

The Company's loans by delinquency and non-accrual status, as of September 30, 2017 and December 31, 2016, were as follows:

|                          | Current<br>&<br>Accruing | 30-59<br>Days Past<br>Due &<br>Accruing | 60-89<br>Days Past<br>Due &<br>Accruing | 90 Days<br>or<br>more Past<br>Due &<br>Accruing | Nonaccrual | Total<br>Loans |
|--------------------------|--------------------------|---|---|---|------------|----------------|
| (\$ in thousands)        |                          |   |   |   |            |                |
| September 30, 2017       |                          |   |   |   |            |                |
| Commercial               | \$ 122,624               | \$ 515                                  | \$ —                                    | \$ —  | \$ 517     | \$ 123,656     |
| Commercial Real Estate   | 363,725                  | 105                                     | —                                       | 755   | 1,765      | 366,350        |
| Agriculture              | 109,140                  | —                                       | —                                       | —   | —          | 109,140        |
| Residential Mortgage     | 42,368                   | 351                                     | —                                       | —   | 125        | 42,844         |
| Residential Construction | 21,969                   | —                                       | —                                       | —   | —          | 21,969         |
| Consumer                 | 39,383                   | 42                                      | 2                                       | —   | 374        | 39,801         |
| Total                    | \$ 699,209               | \$ 1,013                                | \$ 2                                    | \$ 755  | \$ 2,781   | \$ 703,760     |
| December 31, 2016        |                          |   |   |   |            |                |
| Commercial               | \$ 121,311               | \$ —                                    | \$ —                                    | \$ —  | \$ 5,000   | \$ 126,311     |
| Commercial Real Estate   | 343,186                  | 484                                     | —                                       | —   | 540        | 344,210        |
| Agriculture              | 101,905                  | —                                       | —                                       | —   | —          | 101,905        |
| Residential Mortgage     | 39,463                   | —                                       | 120                                     | —   | 654        | 40,237         |
| Residential Construction | 23,650                   | —                                       | —                                       | —   | —          | 23,650         |
| Consumer                 | 43,106                   | —                                       | 41                                      | —   | 103        | 43,250         |
| Total                    | \$ 672,621               | \$ 484                                  | \$ 161                                  | \$ —  | \$ 6,297   | \$ 679,563     |

Non-accrual loans amounted to \$2,781,000 at September 30, 2017 and were comprised of two commercial loans totaling \$517,000, three commercial real estate loans totaling \$1,765,000, two residential mortgage loans totaling \$125,000, and one consumer loan totaling \$374,000. Non-accrual loans amounted to \$6,297,000 at December 31, 2016 and were comprised of one commercial loan totaling \$5,000,000, two commercial real estate loans totaling \$540,000, three residential mortgage loans totaling \$654,000, and one consumer loan totaling \$103,000. All non-accrual loans are measured for impairment based upon the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of collateral, if the loan is collateral dependent. If the measurement of the non-accrual loan is less than the recorded investment in the loan, an impairment is recognized through the establishment of a specific reserve sufficient to cover expected losses and/or a charge-off against the allowance for loan losses. If the loan is considered to be collateral dependent, it is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral. There were no commitments to lend additional funds to borrowers whose loans were on non-accrual status at September 30, 2017.



Impaired Loans

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

Impaired loans, segregated by loan class, as of September 30, 2017 and December 31, 2016 were as follows:

| (\$ in thousands)        | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>with<br>no<br>Allowance | Recorded<br>Investment<br>with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--------------------------|---|---|---|---------------------------------|----------------------|
|                          |   |   |   |                                 |                      |
| September 30, 2017       |   |   |   |                                 |                      |
| Commercial               | \$ 3,297                                      | \$ 517  | \$ 2,660                                    | \$ 3,177                        | \$ 59                |
| Commercial Real Estate   | 2,888   | 1,765   | 1,031                                       | 2,796                           | 40                   |
| Agriculture              | —   | —   | —   | —                               | —                    |
| Residential Mortgage     | 2,653   | 125   | 2,300                                       | 2,425                           | 564                  |
| Residential Construction | 659   | —   | 659   | 659                             | 79                   |
| Consumer                 | 589   | 374   | 215   | 589                             | 4                    |
| Total                    | \$ 10,086                                     | \$ 2,781  | \$ 6,865                                    | \$ 9,646                        | \$ 746               |
| December 31, 2016        |   |   |   |                                 |                      |
| Commercial               | \$ 5,578                                      | \$ —  | \$ 5,578                                    | \$ 5,578                        | \$ 898               |
| Commercial Real Estate   | 885   | 540   | 283   | 823                             | 39                   |
| Agriculture              | —   | —   | —   | —                               | —                    |
| Residential Mortgage     | 3,392   | 654   | 2,380                                       | 3,034                           | 584                  |
| Residential Construction | 820   | —   | 820   | 820                             | 98                   |
| Consumer                 | 708   | 103   | 601   | 704                             | 25                   |
| Total                    | \$ 11,383                                     | \$ 1,297  | \$ 9,662                                    | \$ 10,959                       | \$ 1,644             |

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the three months ended September 30, 2017 and September 30, 2016 was as follows:

| (\$ in thousands)        | Three Months<br>Ended<br>September 30, 2017 |                      | Three Months<br>Ended<br>September 30, 2016 |                      |
|--------------------------|---|----------------------|---|----------------------|
|                          | Average Interest<br>Recorded<br>Investment  | Recognized<br>Income | Average Interest<br>Recorded<br>Investment  | Recognized<br>Income |
| Commercial               | \$3,359                                     | \$ 91                | \$3,232                                     | \$ 6                 |
| Commercial Real Estate   | 2,164                                       | 4                    | 857   | 4                    |
| Agriculture              | —   | —                    | —   | —                    |
| Residential Mortgage     | 2,438                                       | 23                   | 2,973                                       | 24                   |
| Residential Construction | 732   | 9                    | 982   | 12                   |

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|          |         |        |         |       |
|----------|---------|--------|---------|-------|
| Consumer | 590     | 3      | 768     | 9     |
| Total    | \$9,283 | \$ 130 | \$8,812 | \$ 55 |

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The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the nine months ended September 30, 2017 and September 30, 2016 was as follows:

| (\$ in thousands)        | Nine Months Ended<br>September 30, 2017 |                        | Nine Months Ended<br>September 30, 2016 |                        |
|--------------------------|---|------------------------|---|------------------------|
|                          | Average<br>Recorded<br>Investment       | Interest<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Recognized |
| Commercial               | \$4,460                                 | \$ 108                 | \$2,111                                 | \$ 28                  |
| Commercial Real Estate   | 1,487                                   | 12                     | 966                                     | 12                     |
| Agriculture              | —                                       | —                      | —                                       | —                      |
| Residential Mortgage     | 2,733                                   | 77                     | 3,267                                   | 71                     |
| Residential Construction | 774                                     | 28                     | 991                                     | 35                     |
| Consumer                 | 620                                     | 20                     | 890                                     | 62                     |
| Total                    | \$10,074                                | \$ 245                 | \$8,225                                 | \$ 208                 |

Troubled Debt Restructurings

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

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

The Company had \$6,484,000 and \$9,663,000 in TDR loans as of September 30, 2017 and December 31, 2016, respectively. Specific reserves for TDR loans totaled \$743,000 and \$1,644,000 as of September 30, 2017 and December 31, 2016, respectively. TDR loans performing in compliance with modified terms totaled \$6,110,000 and \$4,662,000 as of September 30, 2017 and December 31, 2016, respectively. There were no commitments to advance additional funds on existing TDR loans as of September 30, 2017.

Loans modified as TDRs during the three months ended September 30, 2017 were as follows:

| (\$ in thousands) | Three Months Ended September<br>30, 2017   |  |
|-------------------|--|--|
|                   | Pre-modification<br>Number of<br>Contracts<br>outstanding<br>of recorded<br>investment | Post-<br>modification<br>outstanding<br>recorded<br>investment |
| Commercial        | 1 \$ 2,410   | \$ 2,410   |
| Total             | 1 \$ 2,410   | \$ 2,410   |

There were no loans modified as TDRs during the three months ended September 30, 2016.

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Loans modified as TDRs during the nine months ended September 30, 2017 and September 30, 2016 were as follows:

|            | Nine Months Ended September |              |
|------------|-----------------------------|--------------|
|            | (\$ in thousands) 30, 2017  |              |
|            | Pre-modification            | Post-        |
|            | Number of recorded          | modification |
|            | Contracts                   | outstanding  |
|            | investment                  | recorded     |
|            |                             | investment   |
| Commercial | 1 \$ 2,410                  | \$ 2,410     |
| Total      | 1 \$ 2,410                  | \$ 2,410     |

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Nine Months Ended September

(\$ in thousands) 30, 2016

|            | Pre-modification<br>Number of recorded<br>Contracts | Post-<br>modification<br>outstanding<br>recorded<br>investment |
|------------|---|--|
| Commercial | 1 \$ 180  | \$ 180   |
| Total      | 1 \$ 180  | \$ 180   |

Loan modifications generally involve reductions in the interest rate, payment extensions, forgiveness of principal, or forbearance. The commercial loan that was modified as TDR during the three and nine month periods ended September 30, 2017 involved a payment extension. The commercial loan that was modified as TDR during the three and nine month periods ended September 30, 2016 involved a reduction of the loan amount. There were no loans modified as a TDR within the previous 12 months and for which there was a payment default during the three and nine months ended September 30, 2017 and September 30, 2016.

Credit Quality Indicators

All loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State bank regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and an 8 equates to a Loss. For the definitions of each risk rating, see Note 4 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2016.

The following table presents the risk ratings by loan class as of September 30, 2017 and December 31, 2016:

| (\$ in thousands)        | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|--------------------------|-----------|--------------------|-------------|----------|------|-----------|
| September 30, 2017       |           |                    |             |          |      |           |
| Commercial               | \$115,345 | \$7,518            | \$ 793      | \$ —     | \$ — | \$123,656 |
| Commercial Real Estate   | 352,396   | 11,434             | 2,520       | —        | —    | 366,350   |
| Agriculture              | 105,941   | 3,154              | 45          | —        | —    | 109,140   |
| Residential Mortgage     | 41,132    | 1,579              | 133         | —        | —    | 42,844    |
| Residential Construction | 21,969    | —                  | —           | —        | —    | 21,969    |
| Consumer                 | 38,888    | 500                | 413         | —        | —    | 39,801    |
| Total                    | \$675,671 | \$24,185           | \$ 3,904    | \$ —     | \$ — | \$703,760 |
| December 31, 2016        |           |                    |             |          |      |           |
| Commercial               | \$112,656 | \$7,294            | \$ 6,361    | \$ —     | \$ — | \$126,311 |
| Commercial Real Estate   | 331,653   | 11,058             | 1,499       | —        | —    | 344,210   |
| Agriculture              | 101,820   | —                  | 85          | —        | —    | 101,905   |
| Residential Mortgage     | 37,831    | 1,751              | 655         | —        | —    | 40,237    |
| Residential Construction | 23,070    | 436                | 144         | —        | —    | 23,650    |
| Consumer                 | 41,826    | 547                | 877         | —        | —    | 43,250    |
| Total                    | \$648,856 | \$21,086           | \$ 9,621    | \$ —     | \$ — | \$679,563 |

Allowance for Loan Losses

The following tables detail activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2017.

## Three months ended September 30, 2017

| (\$ in thousands)                | Commercial<br>Real |          | Residential |          |              | Consumer | Unallocated | Total    |
|----------------------------------|--------------------|----------|-------------|----------|--------------|----------|-------------|----------|
|                                  | Commercial         | Estate   | Agriculture | Mortgage | Construction |          |             |          |
| Balance as of June 30, 2017      | \$ 3,060           | \$ 4,883 | \$ 1,375    | \$ 677   | \$ 477       | \$ 378   | \$ 870      | \$11,720 |
| Provision for loan losses        | (547 )             | 577      | 101         | (21 )    | (56 )        | 40       | (94 )       | —        |
| Charge-offs                      | (220 )             | —        | —           | —        | —            | (9 )     | —           | (229 )   |
| Recoveries                       | 26                 | —        | —           | 6        | 2            | 38       | —           | 72       |
| Net (charge-offs) recoveries     | (194 )             | —        | —           | 6        | 2            | 29       | —           | (157 )   |
| Balance as of September 30, 2017 | \$ 2,319           | \$ 5,460 | \$ 1,476    | \$ 662   | \$ 423       | \$ 447   | \$ 776      | \$11,563 |

## Nine months ended September 30, 2017

| (\$ in thousands)                | Commercial<br>Real |          | Residential |          |              | Consumer | Unallocated | Total    |
|----------------------------------|--------------------|----------|-------------|----------|--------------|----------|-------------|----------|
|                                  | Commercial         | Estate   | Agriculture | Mortgage | Construction |          |             |          |
| Balance as of December 31, 2016  | \$ 3,571           | \$ 3,910 | \$ 1,262    | \$ 660   | \$ 440       | \$ 498   | \$ 558      | \$10,899 |
| Provision for loan losses        | (1,181 )           | 1,550    | 214         | (94 )    | (21 )        | (86 )    | 218         | 600      |
| Charge-offs                      | (220 )             | —        | —           | —        | —            | (25 )    | —           | (245 )   |
| Recoveries                       | 149                | —        | —           | 96       | 4            | 60       | —           | 309      |
| Net (charge-offs) recoveries     | (71 )              | —        | —           | 96       | 4            | 35       | —           | 64       |
| Balance as of September 30, 2017 | \$ 2,319           | \$ 5,460 | \$ 1,476    | \$ 662   | \$ 423       | \$ 447   | \$ 776      | \$11,563 |

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, 2017.

| (\$ in thousands)                           | Commercial<br>Real |          | Residential |          |              | Consumer | Unallocated | Total    |
|---|--------------------|----------|-------------|----------|--------------|----------|-------------|----------|
|   | Commercial         | Estate   | Agriculture | Mortgage | Construction |          |             |          |
| Period-end amount allocated to:             |                    |          |             |          |              |          |             |          |
| Loans individually evaluated for impairment | \$ 59              | \$ 40    | \$ —        | \$ 564   | \$ 79        | \$ 4     | \$ —        | \$746    |
| Loans collectively evaluated for impairment | 2,260              | 5,420    | 1,476       | 98       | 344          | 443      | 776         | 10,817   |
| Ending Balance                              | \$ 2,319           | \$ 5,460 | \$ 1,476    | \$ 662   | \$ 423       | \$ 447   | \$ 776      | \$11,563 |

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The following table details activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2016.

Three months ended September 30, 2016

| (\$ in thousands)                | Commercial |             | Residential |          |              | Consumer | Unallocated | Total    |
|----------------------------------|------------|-------------|-------------|----------|--------------|----------|-------------|----------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage | Construction |          |             |          |
| Balance as of June 30, 2016      | \$ 3,175   | \$ 3,584    | \$ 1,150    | \$ 690   | \$ 390       | \$ 555   | \$ 486      | \$10,030 |
| Provision for loan losses        | 556        | 92          | 56          | (25 )    | 7            | (36 )    | (200 )      | 450      |
| Charge-offs                      | (187 )     | —           | —           | —        | —            | (17 )    | —           | (204 )   |
| Recoveries                       | 6          | —           | —           | —        | 2            | 11       | —           | 19       |
| Net (charge-offs) recoveries     | (181 )     | —           | —           | —        | 2            | (6 )     | —           | (185 )   |
| Balance as of September 30, 2016 | \$ 3,550   | \$ 3,676    | \$ 1,206    | \$ 665   | \$ 399       | \$ 513   | \$ 286      | \$10,295 |

Nine months ended September 30, 2016

| (\$ in thousands)                | Commercial |             | Residential |          |              | Consumer | Unallocated | Total    |
|----------------------------------|------------|-------------|-------------|----------|--------------|----------|-------------|----------|
|                                  | Commercial | Real Estate | Agriculture | Mortgage | Construction |          |             |          |
| Balance as of December 31, 2015  | \$ 3,097   | \$ 3,343    | \$ 1,060    | \$ 739   | \$ 334       | \$ 641   | \$ 37       | \$9,251  |
| Provision for loan losses        | 836        | 348         | 65          | (75 )    | 61           | (134 )   | 249         | 1,350    |
| Charge-offs                      | (417 )     | (15 )       | —           | —        | —            | (52 )    | —           | (484 )   |
| Recoveries                       | 34         | —           | 81          | 1        | 4            | 58       | —           | 178      |
| Net (charge-offs) recoveries     | (383 )     | (15 )       | 81          | 1        | 4            | 6        | —           | (306 )   |
| Balance as of September 30, 2016 | \$ 3,550   | \$ 3,676    | \$ 1,206    | \$ 665   | \$ 399       | \$ 513   | \$ 286      | \$10,295 |

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, 2016.

| (\$ in thousands)                           | Commercial |             | Residential |          |              | Consumer | Unallocated | Total    |
|---|------------|-------------|-------------|----------|--------------|----------|-------------|----------|
|   | Commercial | Real Estate | Agriculture | Mortgage | Construction |          |             |          |
| Period-end amount allocated to:             |            |             |             |          |              |          |             |          |
| Loans individually evaluated for impairment | \$ 906     | \$ 40       | \$ —        | \$ 591   | \$ 105       | \$ 38    | \$ —        | \$1,680  |
| Loans collectively evaluated for impairment | 2,644      | 3,636       | 1,206       | 74       | 294          | 475      | 286         | 8,615    |
| Ending Balance                              | \$ 3,550   | \$ 3,676    | \$ 1,206    | \$ 665   | \$ 399       | \$ 513   | \$ 286      | \$10,295 |

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The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the year ended December 31, 2016.

Year ended December 31, 2016

| (\$ in thousands)                           | Commercial |             | Residential |          |              |          | Unallocated | Total    |
|---|------------|-------------|-------------|----------|--------------|----------|-------------|----------|
|   | Commercial | Real Estate | Agriculture | Mortgage | Construction | Consumer |             |          |
| Balance as of December 31, 2015             | \$ 3,097   | \$ 3,343    | \$ 1,060    | \$ 739   | \$ 334       | \$ 641   | \$ 37       | \$9,251  |
| Provision for loan losses                   | 883        | 582         | 121         | (67 )    | 101          | (341 )   | 521         | 1,800    |
| Charge-offs                                 | (446 )     | (15 )       | —           | (13 )    | —            | (65 )    | —           | (539 )   |
| Recoveries                                  | 37         | —           | 81          | 1        | 5            | 263      | —           | 387      |
| Net (charge-offs) recoveries                | (409 )     | (15 )       | 81          | (12 )    | 5            | 198      | —           | (152 )   |
| Ending Balance                              | \$ 3,571   | \$ 3,910    | \$ 1,262    | \$ 660   | \$ 440       | \$ 498   | \$ 558      | \$10,899 |
| Period-end amount allocated to:             |            |             |             |          |              |          |             |          |
| Loans individually evaluated for impairment | \$ 898     | \$ 39       | \$ —        | \$ 584   | \$ 98        | \$ 25    | \$ —        | \$1,644  |
| Loans collectively evaluated for impairment | 2,673      | 3,871       | 1,262       | 76       | 342          | 473      | 558         | 9,255    |
| Balance as of December 31, 2016             | \$ 3,571   | \$ 3,910    | \$ 1,262    | \$ 660   | \$ 440       | \$ 498   | \$ 558      | \$10,899 |

The Company's investment in loans as of September 30, 2017, September 30, 2016, and December 31, 2016 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 |             | Residential |           |              |           | Total     |
|---|------------|-------------|-------------|-----------|--------------|-----------|-----------|
|   | Commercial | Real Estate | Agriculture | Mortgage  | Construction | Consumer  |           |
| September 30, 2017                          |            |             |             |           |              |           |           |
| Loans individually evaluated for impairment | \$ 3,177   | \$ 2,796    | \$ —        | \$ 2,425  | \$ 659       | \$ 589    | \$9,646   |
| Loans collectively evaluated for impairment | 120,479    | 363,554     | 109,140     | 40,419    | 21,310       | 39,212    | 694,114   |
| Ending Balance                              | \$ 123,656 | \$ 366,350  | \$ 109,140  | \$ 42,844 | \$ 21,969    | \$ 39,801 | \$703,760 |
| September 30, 2016                          |            |             |             |           |              |           |           |
| Loans individually evaluated for impairment | \$ 5,647   | \$ 845      | \$ —        | \$ 2,961  | \$ 976       | \$ 763    | \$11,192  |
| Loans collectively evaluated for impairment | 122,192    | 321,777     | 97,257      | 38,719    | 19,620       | 42,789    | 642,354   |
| Ending Balance                              | \$ 127,839 | \$ 322,622  | \$ 97,257   | \$ 41,680 | \$ 20,596    | \$ 43,552 | \$653,546 |
| December 31, 2016                           |            |             |             |           |              |           |           |
| Loans individually evaluated for impairment | \$ 5,578   | \$ 823      | \$ —        | \$ 3,034  | \$ 820       | \$ 704    | \$10,959  |
| Loans collectively evaluated for impairment | 120,733    | 343,387     | 101,905     | 37,203    | 22,830       | 42,546    | 668,604   |
| Ending Balance                              | \$ 126,311 | \$ 344,210  | \$ 101,905  | \$ 40,237 | \$ 23,650    | \$ 43,250 | \$679,563 |





## 5. 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, 2017 for cash proceeds equal to the fair value of the loans.

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

Key assumptions used in measuring the fair value of mortgage servicing rights as of September 30, 2017 and December 31, 2016 were as follows:

|                               | September<br>30, 2017 |   | December<br>31, 2016 |   |
|-------------------------------|-----------------------|---|----------------------|---|
| Constant prepayment rate      | 11.11                 | % | 12.67                | % |
| Discount rate                 | 10.02                 | % | 10.02                | % |
| Weighted average life (years) | 5.91                  |   | 5.51                 |   |

At September 30, 2017 and December 31, 2016, the Company's mortgage loans held-for-sale were \$1,811,000 and \$3,326,000, respectively. At September 30, 2017, and December 31, 2016, the Company serviced real estate mortgage loans for others totaling \$224,961,000 and \$231,310,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2017 and December 31, 2016. Mortgage servicing rights are included in Interest Receivable and Other Assets on the condensed consolidated balance sheets:

|   | (in thousands)          |           |            |                       |
|---|-------------------------|-----------|------------|-----------------------|
|   | December<br>31,<br>2016 | Additions | Reductions | September<br>30, 2017 |
| Mortgage servicing rights                             | \$1,815                 | \$ 161    | \$ (252 )  | \$ 1,724              |
| Valuation allowance                                   | (21 )                   | —         | 21         | —                     |
| Mortgage servicing rights, net of valuation allowance | \$1,794                 | \$ 161    | \$ (231 )  | \$ 1,724              |

At September 30, 2017 and December 31, 2016, the estimated fair market value of the Company's mortgage servicing rights asset was \$1,825,000 and \$1,794,000, respectively.

The Company received contractually specified servicing fees of \$142,000 and \$147,000 for the three months ended September 30, 2017 and September 30, 2016, respectively. The Company received contractually specified servicing fees of \$434,000 and \$444,000 for the nine months ended September 30, 2017 and September 30, 2016, respectively. Contractually specified servicing fees are included in non-interest income on the condensed consolidated statements of income, net of the amortization of the mortgage servicing rights asset.

## 6. FAIR VALUE MEASUREMENTS

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

## 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, 2017:

|   | (in thousands) |  |   |   |
|---|----------------|--|---|---|
|   | Fair Value     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2017                                      |                |  |   |   |
| U.S. Treasury securities                                | \$28,540       | \$28,540   | \$ —  | \$ —                                      |
| Securities of U.S. government agencies and corporations | 22,224         | —  | 22,224  | —   |
| Obligations of states and political subdivisions        | 24,625         | —  | 24,625  | —   |
| Collateralized mortgage obligations                     | 70,376         | —  | 70,376  | —   |
| Mortgage-backed securities                              | 156,490        | —  | 156,490                                       | —   |
| Total investments at fair value                         | \$302,255      | \$28,540   | \$273,715                                     | \$ —                                      |

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

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2016:

|   | (in thousands) |  |   |   |
|---|----------------|--|---|---|
|   | Fair Value     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2016                                       |                |  |   |   |
| U.S. Treasury securities                                | \$28,652       | \$28,652   | \$ —  | \$ —                                      |
| Securities of U.S. government agencies and corporations | 24,197         | —  | 24,197  | —   |

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|  |           |          |           |     |
|--|-----------|----------|-----------|-----|
| Obligations of states and political subdivisions | 30,888    | —        | 30,888    | —   |
| Collateralized mortgage obligations              | 49,938    | —        | 49,938    | —   |
| Mortgage-backed securities                       | 143,404   | —        | 143,404   | —   |
| Total investments at fair value                  | \$277,079 | \$28,652 | \$248,427 | \$— |

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

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of September 30, 2017:

|                            | (in thousands) |         |         |
|----------------------------|----------------|---------|---------|
|                            | Carrying Value | Level 1 | Level 2 |
| September 30, 2017         |                |         |         |
| Impaired loans             | \$517          | \$ —    | \$ —    |
| Total assets at fair value | \$517          | \$ —    | \$ —    |

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of December 31, 2016:

|                            | (in thousands) |         |         |
|----------------------------|----------------|---------|---------|
|                            | Carrying Value | Level 1 | Level 2 |
| December 31, 2016          |                |         |         |
| Impaired loans             | \$4,128        | \$ —    | \$ —    |
| Loan servicing rights      | 1,794          | —       | —       |
| Total assets at fair value | \$5,922        | \$ —    | \$ —    |

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2017 and December 31, 2016.

Key methods and assumptions used in measuring the fair value of impaired loans and loan servicing rights as of September 30, 2017 and December 31, 2016 were as follows:

|                       | Method  | Assumption Inputs  |
|-----------------------|---|--|
| Impaired loans        | Collateral, market, income, enterprise, liquidation and discounted Cash Flows | External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 7%.   |
| Loan servicing rights | Discounted cash flows   | Present value of expected future cash flows was estimated using a discount rate factor of 10.02% as of December 31, 2016. A constant prepayment rate of 12.67% as of December 31, 2016 was utilized. |

The following section describes the valuation methodologies used for assets recorded at fair value.

## Investment Securities Available-for-Sale

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

#### Loans Held-for-Sale

Loans held-for-sale are carried at the lower of cost or fair value. The fair value of loans held-for-sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies loans subjected to non-recurring fair value adjustments as Level 2. At September 30, 2017 and December 31, 2016, there were no loans held-for-sale that required a write-down.

## Impaired Loans

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

At September 30, 2017, certain impaired loans were considered collateral dependent and were evaluated based on the fair value of the underlying collateral securing the loan. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When a loan is evaluated based on the fair value of the underlying collateral securing the loan, the Company records the impaired loan as non-recurring Level 3.

## Other Real Estate Owned

Other real estate assets ("OREO") acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy. At September 30, 2017 and December 31, 2016, there were no OREO that required a write-down.

## Loan Servicing Rights

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

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



## Disclosures about Fair Value of Financial Instruments

The estimated fair values of the Company's financial instruments for the periods ended September 30, 2017 and December 31, 2016 were approximately as follows:

|   |       | September 30, 2017 |            | December 31, 2016 |            |
|---|-------|--------------------|------------|-------------------|------------|
|   | Level | Carrying amount    | Fair value | Carrying amount   | Fair value |
| Financial assets:   |       |                    |            |                   |            |
| Cash and cash equivalents                                   | 1     | \$ 150,156         | \$ 150,156 | \$ 159,643        | \$ 159,643 |
| Certificates of deposit                                     | 2     | 3,968              | 3,970      | 16,213            | 16,230     |
| Stock in Federal Home Loan Bank and other equity securities | 3     | 5,567              | 5,567      | 4,409             | 4,409      |
| Loans receivable:   |       |                    |            |                   |            |
| Net loans   | 3     | 693,066            | 693,497    | 669,770           | 669,437    |
| Loans held-for-sale   | 2     | 1,811              | 1,846      | 3,326             | 3,363      |
| Interest receivable   | 2     | 4,083              | 4,083      | 3,996             | 3,996      |
| Mortgage servicing rights                                   | 3     | 1,724              | 1,825      | 1,794             | 1,794      |
| Financial liabilities:                                      |       |                    |            |                   |            |
| Deposits  | 3     | 1,080,832          | 997,316    | 1,063,696         | 1,001,460  |
| Interest payable  | 2     | 95                 | 95         | 78                | 78         |

The following section describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value on the Balance Sheet.

## Cash and Cash Equivalents

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

## Certificates of Deposit

The Company measures the fair value of Certificates of deposit using Level 2 inputs. The fair values of Certificates of deposit were derived by discounting their future expected cash flows back to their present values based upon a constant maturity curve. The constant maturity curve is based on similar instruments, taking into account factors such as instrument type, coupon type, currency, issuer, sector, country of issuer, credit rating, and prevailing market conditions. The Company believes these inputs fall under Level 2 of the fair value hierarchy.

## Other Equity Securities

The carrying amounts reported in the condensed consolidated balance sheets approximate fair value as the shares can only be redeemed by the issuing institution. The Company believes the measurement of the fair value of other equity securities is derived from Level 3 inputs.

## Loans Receivable

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., commercial real estate and rental property mortgage loans,

commercial and industrial loans, and agricultural loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. Given that the estimation of expected credit losses involves management estimates for assumptions that are not directly observable in a market, the Company believes the fair value of loans receivable is derived from Level 3 inputs.

#### Interest Receivable and Payable

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

## Deposit Liabilities

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

## Limitations

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

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

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

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

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

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

| (in thousands)               | September<br>30, 2017 | December<br>31, 2016 |
|------------------------------|-----------------------|----------------------|
| Undisbursed loan commitments | \$ 223,807            | \$ 207,207           |
| Standby letters of credit    | 2,331                 | 3,518                |
| Commitments to sell loans    | 488                   | 1,848                |
|                              | \$ 226,626            | \$ 212,573           |

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank issues both financial and performance standby letters of credit. The financial standby letters of credit are primarily to guarantee payment to third parties. At September 30, 2017 and December 31, 2016, there were no financial standby letters of credit outstanding. The performance standby letters of credit are typically issued to municipalities as specific performance bonds. Performance standby letters of credit totaled \$2,331,000 and \$3,518,000 at September 30, 2017 and December 31, 2016, respectively. The Bank has experienced no draws on these letters of credit, resulting in no related liability included on their balance sheet, however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of \$850,000 at September 30, 2017 and December 31, 2016, which is recorded in "interest payable and other liabilities" on the Condensed Consolidated Balance Sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of September 30, 2017 and December 31, 2016, the Company had no off-balance sheet derivatives requiring additional disclosure.

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

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

## 8. STOCK PLANS

On January 26, 2017, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2017. All stock options and restricted stock outstanding have been adjusted to give retroactive effect to stock dividends.

The following table presents the activity related to stock options for the three months ended September 30, 2017.

|  | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|--|------------------------|--|---------------------------------|---|
| Options outstanding at Beginning of Period | 250,594                | \$ 7.72                                  |                                 |   |
| Granted                                    | —                      | —  |                                 |   |
| Expired                                    | —                      | —  |                                 |   |
| Cancelled / Forfeited                      | —                      | —  |                                 |   |
| Exercised                                  | —                      | —  |                                 |   |
| Options outstanding at End of Period       | 250,594                | \$ 7.72                                  | \$1,099,604                     | 6.99  |
| Exercisable (vested) at End of Period      | 118,731                | \$ 6.03                                  | \$722,439                       | 5.21  |

The following table presents the activity related to stock options for the nine months ended September 30, 2017.

|  | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>years) |
|--|------------------------|--|---------------------------------|---|
| Options outstanding at Beginning of Period | 227,549                | \$ 8.12                                  |                                 |   |
| Granted                                    | 60,520                 | \$ 11.54                                 |                                 |   |
| Expired                                    | (37,475 )              | \$ 16.31                                 |                                 |   |
| Cancelled / Forfeited                      | —                      | —  |                                 |   |
| Exercised                                  | —                      | —  |                                 |   |
| Options outstanding at End of Period       | 250,594                | \$ 7.72                                  | \$1,099,604                     | 6.99  |
| Exercisable (vested) at End of Period      | 118,731                | \$ 6.03                                  | \$722,439                       | 5.21  |

The weighted average grant date fair value per share of options granted during the nine months ended September 30, 2017 was \$2.78 per share.

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As of September 30, 2017, there was \$256,000 of total unrecognized compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted average period of approximately 2.74 years.

There was \$29,000 and \$82,000 of recognized compensation cost related to stock options granted for the three and nine months ended September 30, 2017, respectively.

A summary of the weighted average assumptions used in valuing stock options during the three and nine months ended September 30, 2017 is presented below:

|                           | Three<br>Months<br>Ended<br>September<br>30, 2017* | Nine<br>Months<br>Ended<br>September<br>30, 2017 |   |
|---------------------------|--|--|---|
| Risk Free Interest Rate   | —  | 1.89   | % |
| Expected Dividend Yield   | —  | 0.00   | % |
| Expected Life in Years    | —  | 5  |   |
| Expected Price Volatility | —  | 22.88  | % |

\* There were no stock options granted during the three months ended September 30, 2017.

The following table presents the activity related to non-vested restricted stock for the three months ended September 30, 2017.

|   | Number<br>of<br>Shares | Weighted<br>Average<br>Grant<br>Date Fair<br>Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual<br>Term (in years) |
|---|------------------------|--|------------------------------|---|
| Non-vested Restricted stock outstanding at<br>Beginning of Period | 106,998                | \$ 8.03  |                              |   |
| Granted   | 1,824                  | 11.96  |                              |   |
| Cancelled / Forfeited   | —                      | \$ —   |                              |   |
| Exercised/Released/Vested   | (1,735 )               | 5.15   |                              |   |
| Non-vested restricted stock outstanding at End of<br>Period       | 107,087                | \$ 8.14  | \$1,295,753                  | 2.71  |

The following table presents the activity related to non-vested restricted stock for the nine months ended September 30, 2017.

|   | Number<br>of<br>Shares | Weighted<br>Average<br>Grant<br>Date Fair<br>Value | Aggregate Intrinsic<br>Value | Weighted Average<br>Remaining<br>Contractual<br>Term (in years) |
|---|------------------------|--|------------------------------|---|
| Non-vested Restricted stock outstanding at Beginning<br>of Period | 99,184                 | \$ 6.70  |                              |   |

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|  |           |          |             |      |
|--|-----------|----------|-------------|------|
| Granted  | 26,441    | \$ 11.50 |             |      |
| Cancelled / Forfeited                                    | (1,463 )  | \$ 6.92  |             |      |
| Exercised/Released/Vested                                | (17,075 ) | \$ 5.08  |             |      |
| Non-vested restricted stock outstanding at End of Period | 107,087   | \$ 8.14  | \$1,295,753 | 2.71 |

The weighted average fair value of restricted stock granted during the nine months ended September 30, 2017 was \$11.50 per share.

As of September 30, 2017, there was \$470,000 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 2.71 years. There was \$53,000 and \$156,000 of recognized compensation cost related to restricted stock awards for the three and nine months ended September 30, 2017, respectively.

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The Company has an Employee Stock Purchase Plan ("ESPP"). There are 270,400 shares authorized under the ESPP. The total number of shares authorized has been adjusted to give retroactive effect to stock dividends and stock splits, including the 4% stock dividend declared on January 26, 2017, payable March 31, 2017 to shareholders of record as of February 28, 2017. The ESPP will expire on March 16, 2026.

The ESPP is implemented by participation periods of not more than 27 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 December 10, 2016 to November 23, 2017. An eligible employee is one who has been continually employed for at least 90 days prior to commencement of a participation period. Under the terms of the ESPP, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company's common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair value on the last trading day before the date of participation or the fair value on the last trading day during the participation period.

As of September 30, 2017, there was \$4,000 of unrecognized compensation cost related to ESPP issuances. This cost is expected to be recognized over a weighted average period of approximately 0.25 years.

There was \$6,000 and \$15,000 of recognized compensation cost related to ESPP issuances for the three and nine months ended September 30, 2017.

The weighted average fair value at issuance date during the nine months ended September 30, 2017 was \$1.74 per share.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three and nine months ended September 30, 2017 is presented below.

|                           | Three<br>Months<br>Ended<br>September<br>30, 2017 |   | Nine<br>Months<br>Ended<br>September<br>30, 2017 |   |
|---------------------------|---|---|--|---|
| Risk Free Interest Rate   | 0.85  | % | 0.85   | % |
| Expected Dividend Yield   | 0.00  | % | 0.00   | % |
| Expected Life in Years    | 1.00  |   | 1.00   |   |
| Expected Price Volatility | 8.18  | % | 8.18   | % |

## 9. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table details activity in accumulated other comprehensive income (loss) for the three months ended September 30, 2017.

| (\$ in thousands)                                | Unrealized<br>Gains<br>(losses) on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|--|--|---------------------------------|----------------------------------|--|
| Balance as of June 30, 2017                      | \$ (1,565 )                                      | \$ (732 )                       | \$ 14                            | \$ (2,283 )  |
| Current period other comprehensive income (loss) | 175  | —                               | —                                | 175  |
| Balance as of September 30, 2017                 | \$ (1,390 )                                      | \$ (732 )                       | \$ 14                            | \$ (2,108 )  |

The following table details activity in accumulated other comprehensive income (loss) for the nine months ended September 30, 2017.

| (\$ in thousands)                                | Unrealized<br>Gains<br>(losses) on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|--|--|---------------------------------|----------------------------------|--|
| Balance as of December 31, 2016                  | \$ (1,678 )                                      | \$ (686 )                       | \$ 14                            | \$ (2,350 )  |
| Current period other comprehensive income (loss) | 288  | (46 )                           | —                                | 242  |
| Balance as of September 30, 2017                 | \$ (1,390 )                                      | \$ (732 )                       | \$ 14                            | \$ (2,108 )  |

The following table details activity in accumulated other comprehensive income (loss) for the three months ended September 30, 2016.

| (\$ in thousands)                                | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|--|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of June 30, 2016                      | \$ 1,061                             | \$ (662 )                       | \$ 17                            | \$ 416   |
| Current period other comprehensive income (loss) | (388 )                               | —                               | —                                | (388 )   |
| Balance as of September 30, 2016                 | \$ 673                               | \$ (662 )                       | \$ 17                            | \$ 28  |

The following table details activity in accumulated other comprehensive income (loss) for the nine months ended September 30, 2016.

| (\$ in thousands)                                | Unrealized<br>Gains on<br>Securities | Officers'<br>retirement<br>plan | Directors'<br>retirement<br>plan | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) |
|--|--------------------------------------|---------------------------------|----------------------------------|--|
| Balance as of December 31, 2015                  | \$ 150                               | \$ (662 )                       | \$ 17                            | \$ (495 )  |
| Current period other comprehensive income (loss) | 523                                  | —                               | —                                | 523  |
| Balance as of September 30, 2016                 | \$ 673                               | \$ (662 )                       | \$ 17                            | \$ 28  |

## 10. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 26, 2017, the Board of Directors of the Company declared a 4% stock dividend payable March 31, 2017 to shareholders of record as of February 28, 2017. All income per share amounts have been adjusted to give retroactive effect to stock dividends.

## Earnings Per Share (EPS)

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

The following table presents a reconciliation of basic and diluted EPS for the three and nine months ended September 30, 2017 and 2016 (dollars in thousands except per share amounts):

|   | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2017                                | 2016       | 2017                               | 2016       |
| Basic earnings per share:                           |                                     |            |                                    |            |
| Net income  | \$2,800                             | \$2,019    | \$7,861                            | \$5,785    |
| Weighted average common shares outstanding          | 11,064,695                          | 11,036,711 | 11,060,920                         | 11,030,473 |
| Basic EPS   | \$0.25                              | \$0.18     | \$0.71                             | \$0.52     |
| Diluted earnings per share:                         |                                     |            |                                    |            |
| Net income  | \$2,800                             | \$2,019    | \$7,861                            | \$5,785    |
| Weighted average common shares outstanding          | 11,064,695                          | 11,036,711 | 11,060,920                         | 11,030,473 |
| Effect of dilutive shares                           | 143,347                             | 72,627     | 140,071                            | 70,924     |
| Adjusted weighted average common shares outstanding | 11,208,042                          | 11,109,338 | 11,200,991                         | 11,101,397 |
| Diluted EPS   | \$0.25                              | \$0.18     | \$0.70                             | \$0.52     |

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 68,398 shares and 148,199 shares for the three months ended September 30, 2017 and 2016, respectively. Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 68,398 shares and 162,367 shares for the nine months ended September 30, 2017 and 2016, respectively.

## 11. GAIN ON SALE-LEASEBACK OF REAL ESTATE

On January 6, 2017, the Company executed a sale-leaseback transaction related to land and building which is partially occupied by our Auburn Branch. The lease carries an initial lease term of six years and is classified as an operating lease. The sale resulted in a total gain of \$1,682, of which \$495 has been deferred as a component of Other Liabilities and will be accounted for as a reduction of Occupancy and equipment expense over the initial lease term. The

Company recognized \$21 and \$56 as a reduction of Occupancy and equipment expense for the three and nine month periods ended September 30, 2017, respectively.

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FIRST NORTHERN COMMUNITY BANCORP

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

FORWARD-LOOKING STATEMENTS

This report may include forward-looking statements, which may include forecasts of our financial results and condition, expectations for our operations and business, and our assumptions for those forecasts and expectations. Do not rely unduly on forward-looking statements. Actual results might differ significantly compared to our forecasts and expectations. See Part I, Item 1A. "Risk Factors," and the other risks described in our 2016 Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q for factors to be considered when reading any forward-looking statements in this filing.

This report and other reports or statements which we may release may include forward-looking statements, which are subject to the "safe harbor" created by section 27A of the Securities Act of 1933, as amended, and section 21E of the Securities Exchange Act of 1934, as amended. We may make forward-looking statements in our Securities and Exchange Commission (SEC) filings, press releases, news articles and when we are speaking on behalf of the Company. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include the words "believe," "expect," "target," "anticipate," "intend," "plan," "seek," "strive," "estimate," "potential," "project," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could," "might," or "may." These forward-looking statements are intended to provide investors with additional information with which they may assess our future potential. All of these forward-looking statements are based on assumptions about an uncertain future and are based on information available to us at the date of these statements. We do not undertake to update forward-looking statements to reflect facts, circumstances, assumptions or events that occur after the date any forward-looking statements are made.

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

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

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

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

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

The costs and effects of legal or regulatory actions

Expectations regarding draws on performance letters of credit

Our regulatory capital requirements, including the capital rules adopted in the past several years by the U.S. federal banking agencies

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

Credit quality and provision for credit losses and management of asset quality and credit risk, and expectations regarding collections

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

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

The seasonal nature of our business

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

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

Our deposit base including renewal of time deposits

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

Expectations regarding an increase or decrease in unrecognized tax benefits

Our pension and retirement plan costs

Our liquidity position

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

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

The possible impact of weather related conditions, including drought or flooding, and related governmental responses on economic conditions, especially in the agricultural sector

Maintenance of insurance coverages appropriate for our operations

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

Descriptions of assumptions underlying or relating to any of the foregoing

Readers of this document should not rely on any forward-looking statements, which reflect only our management's belief as of the date of this report. There are numerous risks and uncertainties that could and will cause actual results to differ materially from those discussed in our forward-looking statements. Many of these factors are beyond our ability to control or predict and could have a material adverse effect on our financial condition and results of operations or prospects. Such risks and uncertainties include, but are not limited to those listed in Item 1A "Risk Factors" of Part II of this Form 10-Q, Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I of this Form 10-Q and "Risk Factors" and "Supervision and Regulation" in our 2016 Annual Report on Form 10-K, and in our other reports to the SEC.

## INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire report and any other reports to the Securities and Exchange Commission ("SEC"), together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2016.

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

Significant results and developments during the third quarter and year-to-date 2017 included:

Net income of \$7.9 million for the nine months ended September 30, 2017, up 36.2% from \$5.8 million earned for the same period last year. Net income of \$2.8 million for the three months ended September 30, 2017, up 40.0% from \$2.0 million for the same period last year.

Diluted income per share of \$0.70 for the nine months ended September 30, 2017, up 34.6% from diluted income per share of \$0.52 in the same period last year. Diluted income per share of \$0.25 for the three months ended September 30, 2017, up 38.9% from diluted income per share of \$0.18 for the same period last year.

Net interest income of \$28.9 million for the nine months ended September 30, 2017, up 12.5% from \$25.7 million for the same period last year. The increase in net interest income was primarily due to an increase in interest income on loans and investment securities. The increase in interest income on loans and investment securities was primarily a result of increased yields and increased average balances of both loans and investment securities.

Net interest margin of 3.49% for the nine months ended September 30, 2017, up 3.6% from 3.37% for the same period ended September 30, 2016.

Provision for loan losses of \$0.6 million for the nine months ended September 30, 2017, down 57.1% from \$1.4 million for the same period ended September 30, 2016.

Total assets of \$1.19 billion as of September 30, 2017, up 2.2% from \$1.17 billion as of December 31, 2016.

Total net loans of \$694.9 million as of September 30, 2017 (including loans held-for-sale), up 3.2% from \$673.1 million as of December 31, 2016.

Total investment securities of \$302.3 million as of September 30, 2017, up 9.1% from \$277.1 million as of December 31, 2016.

Total deposits of \$1.08 billion as of September 30, 2017, up 1.6% from \$1.06 billion as of December 31, 2016.



## SUMMARY FINANCIAL DATA

The Company recorded net income of \$7,861,000 for the nine months ended September 30, 2017, representing an increase of \$2,076,000 or 35.9% from net income of \$5,785,000 for the same period in 2016. The Company recorded net income of \$2,800,000 for the three months ended September 30, 2017, representing an increase of \$781,000 or 38.7% from net income of \$2,019,000 for the same period in 2016.

The following tables present a summary of the results for the three and nine months ended September 30, 2017 and 2016, and a summary of financial condition at September 30, 2017 and December 31, 2016.

|  | Three<br>Months<br>Ended<br>September<br>30, 2017 | Three<br>Months<br>Ended<br>September<br>30, 2016 | Nine<br>Months<br>Ended<br>September<br>30, 2017 | Nine<br>Months<br>Ended<br>September<br>30, 2016 |
|--|---|---|--|--|
| (in thousands except for per share amounts)                    |   |   |  |  |
| For the Period:  |   |   |  |  |
| Net Income   | \$ 2,800  | \$ 2,019  | \$ 7,861   | \$ 5,785   |
| Basic Earnings Per Common Share                                | \$ 0.25   | \$ 0.18   | \$ 0.71  | \$ 0.52  |
| Diluted Earnings Per Common Share                              | \$ 0.25   | \$ 0.18   | \$ 0.70  | \$ 0.52  |
| Net Income to Average Total Assets (annualized)                | 0.95  | % 0.73  | % 0.90   | % 0.72   |
| Net Income to Average Common Shareholders' Equity (annualized) | 11.23   | % 8.76  | % 10.79  | % 8.58   |

|  | September<br>30, 2017 | December<br>31, 2016 |
|--|-----------------------|----------------------|
| (in thousands except for ratios)                 |                       |                      |
| At Period End:                                   |                       |                      |
| Total Assets                                     | \$1,192,850           | \$1,166,763          |
| Total Loans, Net (including loans held-for-sale) | \$694,877             | \$673,096            |
| Total Investment Securities                      | \$302,255             | \$277,079            |
| Total Deposits                                   | \$1,080,832           | \$1,063,696          |
| Loan-To-Deposit Ratio                            | 64.3                  | % 63.3               |

## FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except percentage amounts)

|  | Three months ended<br>September 30, 2017 |          |                       | Three months ended<br>September 30, 2016 |          |                       |
|--|--|----------|-----------------------|--|----------|-----------------------|
|  | Average<br>Balance                       | Interest | Yield/<br>Rate<br>(4) | Average<br>Balance                       | Interest | Yield/<br>Rate<br>(4) |
| Assets   |  |          |                       |  |          |                       |
| Interest-earning assets:                           |  |          |                       |  |          |                       |
| Loans (1)  | \$677,295                                | \$8,394  | 4.92 %                | \$640,262                                | \$7,771  | 4.82 %                |
| Certificate of deposits                            | 3,968                                    | 12       | 1.20 %                | 16,709                                   | 37       | 0.88 %                |
| Interest bearing due from banks                    | 121,681                                  | 407      | 1.33 %                | 133,399                                  | 178      | 0.53 %                |
| Investment securities, taxable                     | 292,051                                  | 1,252    | 1.70 %                | 231,511                                  | 913      | 1.56 %                |
| Investment securities, non-taxable (2)             | 16,915                                   | 61       | 1.43 %                | 13,886                                   | 66       | 1.89 %                |
| Other interest earning assets                      | 5,567                                    | 93       | 6.63 %                | 4,409                                    | 97       | 8.73 %                |
| Total average interest-earning assets              | 1,117,477                                | 10,219   | 3.63 %                | 1,040,176                                | 9,062    | 3.46 %                |
| Non-interest-earning assets:                       |  |          |                       |  |          |                       |
| Cash and due from banks                            | 25,225                                   |          |                       | 24,535                                   |          |                       |
| Premises and equipment, net                        | 6,256                                    |          |                       | 7,488                                    |          |                       |
| Interest receivable and other assets               | 28,798                                   |          |                       | 26,629                                   |          |                       |
| Total average assets                               | \$1,177,756                              |          |                       | \$1,098,828                              |          |                       |
| Liabilities and Stockholders' Equity:              |  |          |                       |  |          |                       |
| Interest-bearing liabilities:                      |  |          |                       |  |          |                       |
| Interest-bearing transaction deposits              | 293,682                                  | 63       | 0.09 %                | 268,419                                  | 76       | 0.11 %                |
| Savings and MMDA's                                 | 333,154                                  | 133      | 0.16 %                | 316,164                                  | 129      | 0.16 %                |
| Time, \$250,000 or less                            | 57,941                                   | 54       | 0.37 %                | 63,330                                   | 64       | 0.40 %                |
| Time, over \$250,000                               | 20,149                                   | 22       | 0.43 %                | 18,927                                   | 20       | 0.42 %                |
| Total average interest-bearing liabilities         | 704,926                                  | 272      | 0.15 %                | 666,840                                  | 289      | 0.17 %                |
| Non-interest-bearing liabilities:                  |  |          |                       |  |          |                       |
| Non-interest-bearing demand deposits               | 362,329                                  |          |                       | 330,420                                  |          |                       |
| Interest payable and other liabilities             | 10,764                                   |          |                       | 9,390                                    |          |                       |
| Total liabilities                                  | 1,078,019                                |          |                       | 1,006,650                                |          |                       |
| Total average stockholders' equity                 | 99,737                                   |          |                       | 92,178                                   |          |                       |
| Total average liabilities and stockholders' equity | \$1,177,756                              |          |                       | \$1,098,828                              |          |                       |
| Net interest income and net interest margin (3)    |  | \$9,947  | 3.53 %                |  | \$8,773  | 3.35 %                |

(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 \$(5) and \$(17) for the three months ended September 30, 2017 and 2016, 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.

(4) For disclosure purposes, yield /rates are annualized by dividing the number of days in the reported period by 365.

## FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except percentage amounts)

|  | Nine months ended<br>September 30, 2017 |          |                       | Nine months ended<br>September 30, 2016 |          |                       |
|--|---|----------|-----------------------|---|----------|-----------------------|
|  | Average<br>Balance                      | Interest | Yield/<br>Rate<br>(4) | Average<br>Balance                      | Interest | Yield/<br>Rate<br>(4) |
| <b>Assets</b>                                      |   |          |                       |   |          |                       |
| <b>Interest-earning assets:</b>                    |   |          |                       |   |          |                       |
| Loans (1)  | \$670,100                               | \$24,566 | 4.90 %                | \$625,403                               | \$22,802 | 4.86 %                |
| Certificate of deposits                            | 8,282                                   | 63       | 1.02 %                | 16,689                                  | 108      | 0.86 %                |
| Interest bearing due from banks                    | 125,247                                 | 979      | 1.05 %                | 144,909                                 | 568      | 0.52 %                |
| Investment securities, taxable                     | 279,149                                 | 3,545    | 1.70 %                | 212,090                                 | 2,577    | 1.62 %                |
| Investment securities, non-taxable (2)             | 18,360                                  | 209      | 1.52 %                | 12,585                                  | 202      | 2.14 %                |
| Other interest earning assets                      | 5,100                                   | 284      | 7.45 %                | 4,214                                   | 274      | 8.66 %                |
| Total average interest-earning assets              | 1,106,238                               | 29,646   | 3.58 %                | 1,015,890                               | 26,531   | 3.48 %                |
| <b>Non-interest-earning assets:</b>                |   |          |                       |   |          |                       |
| Cash and due from banks                            | 24,825                                  |          |                       | 24,398                                  |          |                       |
| Premises and equipment, net                        | 6,139                                   |          |                       | 7,336                                   |          |                       |
| Other real estate owned                            | 0                                       |          |                       | 9                                       |          |                       |
| Interest receivable and other assets               | 28,315                                  |          |                       | 26,395                                  |          |                       |
| Total average assets                               | \$1,165,517                             |          |                       | \$1,074,028                             |          |                       |
| <b>Liabilities and Stockholders' Equity:</b>       |   |          |                       |   |          |                       |
| <b>Interest-bearing liabilities:</b>               |   |          |                       |   |          |                       |
| Interest-bearing transaction deposits              | 291,360                                 | 184      | 0.08 %                | 266,574                                 | 226      | 0.11 %                |
| Savings and MMDA's                                 | 330,778                                 | 378      | 0.15 %                | 301,644                                 | 367      | 0.16 %                |
| Time, \$250,000 or less                            | 58,320                                  | 167      | 0.38 %                | 65,445                                  | 193      | 0.39 %                |
| Time, over \$250,000                               | 20,280                                  | 63       | 0.42 %                | 19,558                                  | 62       | 0.42 %                |
| Total average interest-bearing liabilities         | 700,738                                 | 792      | 0.15 %                | 653,221                                 | 848      | 0.17 %                |
| <b>Non-interest-bearing liabilities:</b>           |   |          |                       |   |          |                       |
| Non-interest-bearing demand deposits               | 357,192                                 |          |                       | 321,900                                 |          |                       |
| Interest payable and other liabilities             | 10,429                                  |          |                       | 9,017                                   |          |                       |
| Total liabilities                                  | 1,068,359                               |          |                       | 984,138                                 |          |                       |
| Total average stockholders' equity                 | 97,158                                  |          |                       | 89,890                                  |          |                       |
| Total average liabilities and stockholders' equity | \$1,165,517                             |          |                       | \$1,074,028                             |          |                       |
| Net interest income and net interest margin (3)    |   | \$28,854 | 3.49 %                |   | \$25,683 | 3.37 %                |

(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 \$21 and \$(125) for the nine months ended September 30, 2017 and 2016, 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.

(4) For disclosure purposes, yield /rates are annualized by dividing the number of days in the reported period by 365.

## FIRST NORTHERN COMMUNITY BANCORP

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

|  | Three months ended<br>September 30, 2017 |          |                | Three months ended<br>June 30, 2017 |          |                |
|--|--|----------|----------------|-------------------------------------|----------|----------------|
|  | Average<br>Balance                       | Interest | Yield/<br>Rate | Average<br>Balance                  | Interest | Yield/<br>Rate |
| Assets   |  |          |                |                                     |          |                |
| Interest-earning assets:                           |  |          |                |                                     |          |                |
| Loans (1)  | \$677,295                                | \$8,394  | 4.92 %         | \$672,786                           | \$8,211  | 4.90 %         |
| Certificates of deposit                            | 3,968                                    | 12       | 1.20 %         | 4,852                               | 15       | 1.24 %         |
| Interest bearing due from banks                    | 121,681                                  | 407      | 1.33 %         | 114,494                             | 276      | 0.97 %         |
| Investment securities, taxable                     | 292,051                                  | 1,252    | 1.70 %         | 281,357                             | 1,191    | 1.70 %         |
| Investment securities, non-taxable (2)             | 16,915                                   | 61       | 1.43 %         | 19,080                              | 73       | 1.53 %         |
| Other interest earning assets                      | 5,567                                    | 93       | 6.63 %         | 5,313                               | 83       | 6.27 %         |
| Total average interest-earning assets              | 1,117,477                                | 10,219   | 3.63 %         | 1,097,882                           | 9,849    | 3.60 %         |
| Non-interest-earning assets:                       |  |          |                |                                     |          |                |
| Cash and due from banks                            | 25,225                                   |          |                | 24,786                              |          |                |
| Premises and equipment, net                        | 6,256                                    |          |                | 6,065                               |          |                |
| Interest receivable and other assets               | 28,798                                   |          |                | 28,361                              |          |                |
| Total average assets                               | \$1,177,756                              |          |                | \$1,157,094                         |          |                |
| Liabilities and Stockholders' Equity:              |  |          |                |                                     |          |                |
| Interest-bearing liabilities:                      |  |          |                |                                     |          |                |
| Interest-bearing transaction deposits              | 293,682                                  | 63       | 0.09 %         | 291,423                             | 61       | 0.08 %         |
| Savings and MMDA's                                 | 333,154                                  | 133      | 0.16 %         | 324,552                             | 117      | 0.14 %         |
| Time, \$250,000 and under                          | 57,941                                   | 54       | 0.37 %         | 58,333                              | 54       | 0.37 %         |
| Time, over \$250,000                               | 20,149                                   | 22       | 0.43 %         | 20,800                              | 23       | 0.44 %         |
| Total average interest-bearing liabilities         | 704,926                                  | 272      | 0.15 %         | 695,108                             | 255      | 0.15 %         |
| Non-interest-bearing liabilities:                  |  |          |                |                                     |          |                |
| Non-interest-bearing demand deposits               | 362,329                                  |          |                | 354,590                             |          |                |
| Interest payable and other liabilities             | 10,764                                   |          |                | 10,387                              |          |                |
| Total liabilities                                  | 1,078,019                                |          |                | 1,060,085                           |          |                |
| Total average stockholders' equity                 | 99,737                                   |          |                | 97,009                              |          |                |
| Total average liabilities and stockholders' equity | \$1,177,756                              |          |                | \$1,157,094                         |          |                |
| Net interest income and net interest margin (3)    |  | \$9,947  | 3.53 %         |                                     | \$9,594  | 3.51 %         |

(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 is excluded. Loan interest income includes loan fees of approximately \$(5) and \$10 for the three months ended September 30, 2017 and June 30, 2017, 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.

(4) For disclosure purposes, yield/rates are annualized by dividing the number of days in the reported period by 365.

Analysis of Changes  
in Interest Income and Interest Expense  
(Dollars in thousands)

Following is an analysis of changes in interest income and expense (dollars in thousands) for the three months ended September 30, 2017 over the three months ended September 30, 2016, the nine months ended September 30, 2017 over the nine months ended September 30, 2016, and the three months ended September 30, 2017 over the three months ended June 30, 2017. Changes not solely due to interest rate or volume have been allocated proportionately to interest rate and volume.

|  | Three Months Ended<br>September 30, 2017<br>Over<br>Three Months Ended<br>September 30, 2016 |          |          | Nine Months Ended<br>September 30, 2017<br>Over<br>Nine Months Ended<br>September 30, 2016 |          |         | Three Months Ended<br>September 30, 2017<br>Over<br>Three Months Ended<br>June 30, 2017 |        |        |
|--|--|----------|----------|--|----------|---------|---|--------|--------|
|  | Volume   | Rate     | Change   | Volume   | Rate     | Change  | Volume  | Rate   | Change |
| Increase (Decrease) in Interest Income:  |  |          |          |  |          |         |   |        |        |
| Loans                                    | \$462  | \$ 149   | \$ 611   | \$1,591  | \$ 27    | \$1,618 | \$57  | \$ 141 | \$ 198 |
| Loan Fees                                | 12   | —        | 12       | 146  | —        | 146     | (15)  | —      | (15 )  |
| Due From Banks                           | (17 )  | 246      | 229      | (87 )  | 498      | 411     | 19  | 112    | 131    |
| Certificates of Deposit                  | (35 )  | 10       | (25 )    | (62 )  | 17       | (45 )   | (3 )  | —      | (3 )   |
| Investment Securities                    | 269  | 65       | 334      | 918  | 57       | 975     | 35  | 14     | 49     |
| Other Assets                             | 22   | (26 )    | (4 )     | 52   | (42 )    | 10      | 4   | 6      | 10     |
|  | \$713  | \$ 444   | \$ 1,157 | \$2,558  | \$ 557   | \$3,115 | \$97  | \$ 273 | \$ 370 |
| Increase (Decrease) in Interest Expense: |  |          |          |  |          |         |   |        |        |
| Deposits:                                |  |          |          |  |          |         |   |        |        |
| Interest-Bearing Transaction             |  |          |          |  |          |         |   |        |        |
| Deposits                                 | \$5  | \$ (18 ) | \$(13 )  | \$20   | \$ (62 ) | \$(42 ) | \$—   | \$ 2   | \$ 2   |
| Savings & MMDAs                          | 4  | —        | 4        | 35   | (24 )    | 11      | 3   | 13     | 16     |
| Time Certificates                        | (5 )   | (3 )     | (8 )     | (21 )  | (4 )     | (25 )   | (1 )  | —      | (1 )   |
|  | \$4  | \$ (21 ) | \$(17 )  | \$34   | \$ (90 ) | \$(56 ) | \$2   | \$ 15  | \$ 17  |
| Increase in Net Interest Income:         | \$709  | \$ 465   | \$ 1,174 | \$2,524  | \$ 647   | \$3,171 | \$95  | \$ 258 | \$ 353 |

## CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a \$9,487,000 or 5.9% decrease in cash and cash equivalents, a \$12,245,000 or 75.5% decrease in certificates of deposit, a \$25,176,000 or 9.1% increase in investment securities available-for-sale, a \$23,296,000 or 3.5% increase in net loans held-for-investment, a \$1,515,000 or 45.6% decrease in loans held-for-sale, a \$1,158,000 or 26.3% increase in stock in Federal Home Loan Bank and other equity securities, and a \$921,000 or 12.6% decrease in premises and equipment from December 31, 2016 to September 30, 2017. The decrease in cash and cash equivalents was primarily due to a decrease in interest bearing due from Federal Reserve Bank accounts, which was mainly due to the purchase of investment securities. The increase in investment securities available-for-sale was primarily the result of the purchases of mortgage-backed securities and collateralized mortgage obligations, which was partially offset by sales, calls and maturities of U.S. government agencies, mortgage-backed securities, and municipal securities. The increase in net loans held-for-investment was primarily due to increased demand for commercial real estate, agriculture, and residential mortgage, which was partially offset by decreased demand for commercial, residential construction, and consumer loans. The decrease in loans held-for-sale was due to timing of sales of loans held-for-sale. The increase in stock in Federal Home Loan Bank and other equity securities was due to the purchase of Federal Home Loan Bank stock. The decrease in premises and equipment was due to a sale-leaseback of land and building partially occupied by a Bank branch.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of \$17,136,000 or 1.6% from December 31, 2016 to September 30, 2017. The increase in deposits was due to increases in interest-bearing transaction deposits, savings accounts, and time deposits over \$250,000, which were partially offset by decreases in demand accounts, money market accounts, and time deposits \$250,000 or less.

## CHANGES IN RESULTS OF OPERATIONS

### Interest Income

The Federal Open Market Committee increased the Federal Funds rate 50 basis points from 0.75% to 1.25% during the nine months ended September 30, 2017.

Interest income on loans for the nine months ended September 30, 2017 was up 7.7% from the same period in 2016, increasing from \$22,802,000 to \$24,566,000, and was up 8.0% for the three months ended September 30, 2017 over the same period in 2016, increasing from \$7,771,000 to \$8,394,000. The increase in interest income on loans for the nine months ended September 30, 2017 as compared to the same period a year ago was primarily due to an increase in average loans and a 4 basis point increase in loan yields. The increase in interest income on loans for the three months ended September 30, 2017 as compared to the same period a year ago was primarily due to an increase in average loans and a 10 basis point increase in loan yields. The increase in loan yields was primarily due to the origination of new loans and the repricing of existing loans at higher rates.

Interest income on investment securities available-for-sale for the nine months ended September 30, 2017 was up 35.1% from the same period in 2016, increasing from \$2,779,000 to \$3,754,000, and was up 34.1% for the three months ended September 30, 2017 over the same period in 2016, increasing from \$979,000 to \$1,313,000. The increase in interest income on investment securities for the nine months ended September 30, 2017 as compared to the same period a year ago was due to an increase in average investment securities and a 4 basis point increase in investment yields. The increase in interest income on investment securities for the three months ended September 30, 2017 as compared to the same period a year ago was primarily due to an increase in average investment securities and an 11 basis point increase in investment yields.

Interest income on interest-bearing due from banks for the nine months ended September 30, 2017 was up 72.4% from the same period in 2016, increasing from \$568,000 to \$979,000, and was up 128.7% for the three months ended September 30, 2017 over the same period in 2016, increasing from \$178,000 to \$407,000. The increase in interest income on interest-bearing due from banks for the nine months ended September 30, 2017 as compared to the same period a year ago was due to a 53 basis point increase in yield on interest-bearing due from banks due to an increase in the Federal Funds rate, which was partially offset by a decrease in average balances of interest-bearing due from banks. The increase in interest income on interest-bearing due from banks for the three months ended September 30, 2017 as compared to the same period a year ago was due to an 80 basis point increase in yield on interest-bearing due from banks due to an increase in the Federal Funds rate, which was partially offset by a decrease in average balances of interest-bearing due from banks.

Interest income on certificates of deposit for the nine months ended September 30, 2017 was down 41.7% from the same period in 2016, decreasing from \$108,000 to \$63,000, and was down 67.6% for the three months ended September 30, 2017 over the same period in 2016, decreasing from \$37,000 to \$12,000. The decrease in interest income on certificates of deposit for the nine months ended September 30, 2017 as compared to the same period a year ago was due to a decrease in average balances of certificates of deposit due to maturities, which was partially offset by a 16 basis point increase in yield on certificates of deposit. The decrease in interest income on certificates of deposit for the three months ended September 30, 2017 as compared to the same period a year ago was due to a decrease in average balances of certificates of deposit due to maturities, which was partially offset by a 32 basis point increase in yield on certificates of deposit.

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Interest income on other earning assets for the nine months ended September 30, 2017 was up 3.7% from the same period in 2016, increasing from \$274,000 to \$284,000, and was down 4.1% for the three months ended September 30, 2017 over the same period in 2016, decreasing from \$97,000 to \$93,000. The increase in interest income on other assets for the nine months ended September 30, 2017 as compared to the same period a year ago was due to an increase in average balances of other earning assets, which was partially offset by a 121 basis point decrease in yield on other earning assets. The decrease in interest income on other earning assets for the three months ended September 30, 2017 as compared to the same period a year ago was due to a 210 basis point decrease in yield on other earning assets, which was partially offset by an increase in average balances of other earning assets.

The Company had no Federal Funds sold balances during the three and nine months ended September 30, 2017 and September 30, 2016.

### Interest Expense

Interest expense on deposits and other borrowings for the nine months ended September 30, 2017 was down 6.6% from the same period in 2016, decreasing from \$848,000 to \$792,000, and was down 5.9% for the three months ended September 30, 2017 over the same period in 2016, decreasing from \$289,000 to \$272,000. The decrease in interest expense during the three and nine months ended September 30, 2017 was primarily due to a 2 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in the average balance of interest-bearing liabilities.

The Company had no FHLB advances and related interest expense during the three and nine months ended September 30, 2017 and September 30, 2016.

### Provision for Loan Losses

There was a provision for loan losses of \$600,000 for the nine months ended September 30, 2017 compared to \$1,350,000 for the same period in 2016. There was no provision for loan losses for the three months ended September 30, 2017 compared to \$450,000 for the same period in 2016. The allowance for loan losses was approximately \$11,563,000 or 1.64% of total loans, at September 30, 2017, compared to \$10,899,000, or 1.60% of total loans, at December 31, 2016. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

The decrease in the provision for loan losses during the three and nine months ended September 30, 2017 was primarily due to decreased charge-offs and increased recoveries coupled with a decrease in specific reserves on impaired loans, which was partially offset by an increase in loan balances as well as an increase in qualitative risk factors compared to the same periods in 2016. The increase in qualitative risk factors were primarily for commercial, commercial real estate and consumer loans and were primarily due to increased concentration risk, personnel changes and various economic factors.

### Provision for Unfunded Lending Commitment Losses

There was a provision for unfunded lending commitment losses of \$0 and \$57,000 for the three and nine months ended September 30, 2017, respectively, compared to \$0 for the three and nine months ended September 30, 2016. The increase in provision for unfunded lending commitment losses was primarily due to an increase in qualitative risk factors compared to the same periods in 2016.

The provision for unfunded lending commitment losses is included in non-interest expense in the Condensed Consolidated Statements of Income.

### Non-Interest Income



Non-Interest income was up 22.8% for the nine months ended September 30, 2017 from the same period in 2016, increasing from \$5,197,000 to \$6,380,000.

The increase was primarily due to the recognition of a pre-tax gain of \$1,187,000 on a sale-leaseback transaction related to land and building which is partially occupied by a Bank branch. The lease carries an initial lease term of six years and is classified as an operating lease. The sale resulted in a total gain of \$1,682,000, of which \$495,000 was deferred as a component of Other Liabilities and is being accounted for as a reduction of Occupancy and equipment expense over the initial lease term.

In addition, there were increases in investment and brokerage services income, mortgage brokerage income, loan servicing income, and fiduciary activities income, which was partially offset by decreases in service charges on deposit accounts, gains on sales of loans held-for-sale, and other income. The increase in investment and brokerage income, mortgage brokerage income, and fiduciary activities income was primarily due to an increase in demand for those services. The increase in loan servicing income was primarily due to the reversal of impairment expense in the current period. The decrease in service charges on deposit accounts was primarily due to decreases in fees charged. The decrease in gains on sales of loans held-for-sale was primarily due to a decrease in the volume of loans-held-for-sale. The decrease in other income was primarily due to a decrease in rental income due to the sale of land and building in the current period.

Non-Interest income was up 7.4% for the three months ended September 30, 2017 from the same period in 2016, increasing from \$1,657,000 to \$1,780,000.

The increase was primarily due to increases in service charges on deposit accounts, investment and brokerage services income, mortgage brokerage income, loan servicing income and gains on sales of available-for-sale securities, which was partially offset by decreases in gains on sales of loans held-for-sale and other income. The increase in service charges on deposit accounts was primarily due to increases in fees charged. The increase in investment and brokerage services and mortgage brokerage income was primarily due to an increase in demand for those services. The increase in loan servicing income was primarily due to the recognition of impairment expense in the prior period. The increase in gains on sales of available-for-sale securities was primarily due to increased values of securities sold and current market pricing at the time of sale. The decrease in gains on sales of loans held-for-sale was primarily due to a decrease in the volume of loans-held-for-sale. The decrease in other income is primarily due to a decrease in rental income due to the sale of land and building in the current period.

#### Non-Interest Expenses

Total non-interest expenses were up 8.2% for the nine months ended September 30, 2017 from the same period in 2016, increasing from \$20,226,000 to \$21,884,000.

The increase was primarily due to increases in salaries and employee benefits, data processing, and other expenses, which was partially offset by a decrease in occupancy and equipment expense. The increase in salaries and employee benefits was primarily due to an increase in staffing and associated salary expense and profit sharing. The increase in data processing was primarily due to increases in general data processing costs. The increase in other expenses was primarily due to increases in provision for unfunded loan commitments, and consulting fees, which was partially offset by decreases in FDIC assessments and postage expense. The decrease in occupancy and equipment expense was primarily due to a decrease in rent expense due to the expiration of a lease and the amortization of the deferred portion of the gain on sale of lease-back transaction discussed in Non-Interest Income above.

Total non-interest expenses were up 8.5% for the three months ended September 30, 2017 from the same period in 2016, increasing from \$6,599,000 to \$7,161,000.

The increase was primarily due to increases in salaries and employee benefits and other expenses, which was partially offset by a decrease in occupancy and equipment expense. The increase in salaries and employee benefits was primarily due to an increase in staffing and associated salary expense and profit sharing. The increase in other expenses was primarily due to an increase in consulting fees, which were partially offset by a decrease in FDIC assessments. The decrease in occupancy and equipment expense was primarily due to a decrease in rent expense due to the expiration of a lease and the amortization of the deferred portion of the gain on sale of lease-back transaction discussed in Non-Interest Income above.

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The following table sets forth other non-interest expenses by category for the three and nine months ended September 30, 2017 and 2016.

|   | (in thousands) |           |           |           |
|---|----------------|-----------|-----------|-----------|
|   | Three          | Three     | Nine      | Nine      |
|   | months         | months    | months    | months    |
|   | ended          | ended     | ended     | ended     |
|   | September      | September | September | September |
|   | 30,            | 30,       | 30,       | 30,       |
|   | 2017           | 2016      | 2017      | 2016      |
| <u>Other non-interest expenses</u>      |                |           |           |           |
| Provision for unfunded loan commitments | \$—            | \$ —      | \$ 57     | \$ —      |
| FDIC assessments                        | 95             | 140       | 365       | 450       |
| Contributions                           | 32             | 37        | 127       | 92        |
| Legal fees                              | 85             | 66        | 189       | 204       |
| Accounting and audit fees               | 102            | 84        | 285       | 269       |
| Consulting fees                         | 169            | 63        | 530       | 364       |
| Postage expense                         | 56             | 63        | 185       | 217       |
| Telephone expense                       | 32             | 37        | 97        | 109       |
| Public relations                        | 44             | 41        | 147       | 172       |
| Training expense                        | 31             | 45        | 107       | 117       |
| Loan origination expense                | 40             | 12        | 131       | 102       |
| Computer software depreciation          | 40             | 40        | 114       | 103       |
| Sundry losses                           | 41             | (34 )     | 189       | 46        |
| Loan collection expense                 | 15             | 13        | 75        | 56        |
| Other non-interest expense              | 502            | 516       | 1,519     | 1,454     |
| Total other non-interest expenses       | \$1,284        | \$ 1,123  | \$ 4,117  | \$ 3,755  |

Income Taxes

The Company's tax rate, the Company's income 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, 2017, the Company's expense for income taxes increased \$1,370,000 or 38.9% from the same period last year, from \$3,519,000 to \$4,889,000.

In the three months ended September 30, 2017, the Company's expense for income taxes increased \$404,000 or 29.7% from the same period last year, from \$1,362,000 to \$1,766,000.

The increase in provision for income taxes for the period presented is primarily attributable to the respective levels of taxable 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, and excludable interest income.

Off-Balance Sheet Commitments

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

(in thousands)

September December  
30, 2017 31, 2016

|                              |           |           |
|------------------------------|-----------|-----------|
| Undisbursed loan commitments | \$223,807 | \$207,207 |
| Standby letters of credit    | 2,331     | 3,518     |
| Commitments to sell loans    | 488       | 1,848     |
|                              | \$226,626 | \$212,573 |

The reserve for unfunded lending commitments amounted to \$850,000 and \$793,000 as of September 30, 2017 and December 31, 2016, respectively. The reserve for unfunded lending commitments is included in other liabilities on the Condensed Consolidated Balance Sheets. See Note 7 of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q, "Financial Instruments with Off-Balance Sheet Risk," for additional information.

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 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 or improbable.

Other Real Estate Owned and loans rated Substandard and Doubtful are deemed "classified assets". This category, which includes both performing and non-performing assets, receives an elevated level of attention regarding collection.

The following tables summarize the Company's non-accrual loans net of guarantees of the State of California and U.S. Government by loan category at September 30, 2017 and December 31, 2016:

|                          | At September 30, 2017 |            |         | At December 31, 2016 |            |         |
|--------------------------|-----------------------|------------|---------|----------------------|------------|---------|
|                          | Gross                 | Guaranteed | Net     | Gross                | Guaranteed | Net     |
| (in thousands)           |                       |            |         |                      |            |         |
| Commercial               | \$517                 | \$ —       | \$517   | \$5,000              | \$ 2,000   | \$3,000 |
| Commercial real estate   | 1,765                 | 72         | 1,693   | 540                  | 81         | 459     |
| Agriculture              | —                     | —          | —       | —                    | —          | —       |
| Residential mortgage     | 125                   | —          | 125     | 654                  | —          | 654     |
| Residential construction | —                     | —          | —       | —                    | —          | —       |
| Consumer                 | 374                   | —          | 374     | 103                  | —          | 103     |
| Total non-accrual loans  | \$2,781               | \$ 72      | \$2,709 | \$6,297              | \$ 2,081   | \$4,216 |

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 \$2,781,000 at September 30, 2017 and were comprised of two commercial loans totaling \$517,000, three commercial real estate loans totaling \$1,765,000, two residential mortgage loans totaling \$125,000 and one consumer loan totaling \$374,000. Non-accrual loans amounted to \$6,297,000 at December 31, 2016 and were comprised of one commercial loan totaling \$5,000,000, two commercial real estate loans totaling \$540,000, three residential mortgage loans totaling \$654,000, and one consumer loan totaling \$103,000. If the loan is collateral dependent, it is generally the Company's policy to charge-off the portion of any non-accrual loan that the

Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Non-performing impaired loans are non-accrual loans and loans that are 90 days or more past due and still accruing. Total non-performing impaired loans at September 30, 2017 and December 31, 2016 consisting of loans on non-accrual status totaled \$2,781,000 and \$6,297,000, respectively. A restructuring of a loan can constitute a TDR if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A loan that is restructured in a TDR is considered an impaired loan. Performing impaired loans totaled \$6,865,000 and \$4,662,000 at September 30, 2017 and December 31, 2016, respectively. Performing impaired loans consist of loans modified as TDRs totaling \$6,110,000 and other impaired loans totaling \$755,000. The Company expects to collect all principal and interest due from performing impaired loans. These loans are not on non-accrual status. The majority of the non-performing impaired loans, in management's opinion, were adequately collateralized based on recently obtained appraised property values or were guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

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As the following table illustrates, total non-performing assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased \$752,000, or 17.8%, to \$3,464,000 during the first nine months of 2017. Non-performing assets, net of guarantees, represented 0.3% of total assets at September 30, 2017.

| (dollars in thousands)  | At September 30, 2017 |            |         | At December 31, 2016 |            |         |
|---|-----------------------|------------|---------|----------------------|------------|---------|
|   | Gross                 | Guaranteed | Net     | Gross                | Guaranteed | Net     |
| Non-accrual loans   | \$2,781               | \$ 72      | \$2,709 | \$6,297              | \$ 2,081   | \$4,216 |
| Loans 90 days past due and still accruing                                       | 755                   | —          | 755     | —                    | —          | —       |
| Total non-performing loans  | 3,536                 | 72         | 3,464   | 6,297                | 2,081      | 4,216   |
| Other real estate owned   | —                     | —          | —       | —                    | —          | —       |
| Total non-performing assets   | \$3,536               | \$ 72      | \$3,464 | \$6,297              | \$ 2,081   | \$4,216 |
| Non-performing loans (net of guarantees) to total loans                         |                       |            | 0.5 %   |                      |            | 0.6 %   |
| Non-performing assets (net of guarantees) to total assets                       |                       |            | 0.3 %   |                      |            | 0.4 %   |
| Allowance for loan and lease losses to non-performing loans (net of guarantees) |                       |            | 333.8 % |                      |            | 258.5 % |

The Company had one loan totaling \$755,000 that was 90 days or more past due and still accruing at September 30, 2017 and no loans 90 days or more past due and still accruing at December 31, 2016.

Excluding the non-performing loans cited previously, loans totaling \$368,000 and \$3,324,000 were classified as substandard or doubtful loans, representing potential problem loans at September 30, 2017 and December 31, 2016, respectively. In Management's opinion, the potential loss related to these problem loans was sufficiently covered by the Bank's existing loan loss reserve (Allowance for Loan Losses) at September 30, 2017 and December 31, 2016. The ratio of the Allowance for Loan Losses to total loans at September 30, 2017 and December 31, 2016 was 1.64% and 1.60%, respectively.

Other real estate owned ("OREO") consists of property that the Company has acquired by deed in lieu of foreclosure or through foreclosure proceedings, and property that the Company does not hold title to but is in actual control of, known as in-substance foreclosure. The estimated fair value of the property is determined prior to transferring the balance to OREO. The balance transferred to OREO is the estimated fair value of the property less estimated cost to sell. Impairment may be deemed necessary to bring the book value of the loan equal to the appraised value. Appraisals or loan officer evaluations are then conducted periodically thereafter charging any additional impairment to the appropriate expense account. The Company had no OREO as of September 30, 2017 and December 31, 2016.

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

The following table summarizes the Allowance for Loan Losses of the Company during the nine months ended September 30, 2017 and 2016, and for the year ended December 31, 2016:

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

|   | Nine months ended |               | Year ended   |
|---|-------------------|---------------|--------------|
|   | September 30,     | September 30, | December 31, |
|   | 2017              | 2016          | 2016         |
| Balance at beginning of period  | \$10,899          | \$9,251       | \$ 9,251     |
| Provision for loan losses   | 600               | 1,350         | 1,800        |
| Loans charged-off:  |                   |               |              |
| Commercial  | (220 )            | (417 )        | (446 )       |
| Commercial Real Estate  | —                 | (15 )         | (15 )        |
| Agriculture   | —                 | —             | —            |
| Residential Mortgage  | —                 | —             | (13 )        |
| Residential Construction  | —                 | —             | —            |
| Consumer  | (25 )             | (52 )         | (65 )        |
| Total charged-off   | (245 )            | (484 )        | (539 )       |
| Recoveries:   |                   |               |              |
| Commercial  | 149               | 34            | 37           |
| Commercial Real Estate  | —                 | —             | —            |
| Agriculture   | —                 | 81            | 81           |
| Residential Mortgage  | 96                | 1             | 1            |
| Residential Construction  | 4                 | 4             | 5            |
| Consumer  | 60                | 58            | 263          |
| Total recoveries  | 309               | 178           | 387          |
| Net recoveries (charge-offs)  | 64                | (306 )        | (152 )       |
| Balance at end of period  | \$11,563          | \$10,295      | \$ 10,899    |
| Ratio of net recoveries (charge-offs) to average loans outstanding during the period (annualized) | 0.01 %            | (0.06 %)      | (0.02 %)     |
| Allowance for loan losses   |                   |               |              |



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|   |       |   |       |   |       |   |
|---|-------|---|-------|---|-------|---|
| To total loans at the end of the period                             | 1.64  | % | 1.58  | % | 1.60  | % |
| To non-performing loans, net of guarantees at the end of the period | 333.8 | % | 243.5 | % | 258.5 | % |

The allowance for loan losses to non-performing loans, net of guarantees was 333.8% and 243.5% as of September 30, 2017 and September 30, 2016, respectively. The increase in allowance for loan losses to non-performing loans, net of guarantees, was due to an increase in allowance for loan losses and a decrease in non-performing loans. The increase in allowance for loan losses during the nine months ended September 30, 2017 was due to an increase in total loans as well as an increase in qualitative risk factors primarily for commercial, commercial real estate and consumer loans. The increase in qualitative risk factors were primarily due to increased concentration risk, personnel changes and various economic factors.

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Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2017, the Company had the following deposit mix: 31.3% in savings and MMDA deposits, 7.2% in time deposits, 28.0% in interest-bearing transaction deposits and 33.5% in non-interest-bearing transaction deposits. At December 31, 2016, the Company had the following deposit mix: 31.2% in savings and MMDA deposits, 7.1% in time deposits, 27.6% in interest-bearing transaction deposits and 34.1% in non-interest-bearing transaction deposits. Non-interest-bearing transaction deposits increase the Company's net interest income by lowering its cost of funds.

The Company obtains deposits primarily from the communities it serves. The Company believes that no material portion of its deposits has been obtained from or is dependent on any one person or industry. The Company accepts deposits in excess of \$250,000 from customers.

Maturities of time certificates of deposits of over \$250,000 outstanding at September 30, 2017 and December 31, 2016 are summarized as follows:

|                             | (in thousands) |           |
|-----------------------------|----------------|-----------|
|                             | September      |           |
|                             | 30,            | December  |
|                             | 2017           | 31, 2016  |
| Three months or less        | \$5,281        | \$ 2,676  |
| Over three to twelve months | 6,972          | 10,058    |
| Over twelve months          | 7,761          | 2,524     |
| Total                       | \$20,014       | \$ 15,258 |

Liquidity and Capital Resources

In order to serve our market area, the Company must maintain adequate liquidity and adequate capital. Liquidity is measured by various ratios; in management's opinion, the most common being the ratio of net loans to deposits (including loans held-for-sale). This ratio was 64.3% on September 30, 2017. In addition, on September 30, 2017, the Company had the following short-term investments (based on remaining maturity and/or next repricing date): \$29,319,000 in securities due within one year or less; and \$44,881,000 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 which totaled \$80,000,000 at September 30, 2017. Additionally, the Company has a line of credit with the FHLB, with a borrowing capacity at September 30, 2017 of \$293,833,000; credit availability is subject to certain collateral requirements.

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, 2017, the Bank's capital ratios exceeded applicable regulatory requirements. The following table presents the capital ratios for the Bank, compared to the regulatory standards for well-capitalized depository institutions, as of September 30, 2017.

| (amounts in thousands except<br>percentage amounts) |       |             |
|---|-------|-------------|
| Actual  |       | Well        |
| Capital   | Ratio | Capitalized |
|   |       | Ratio       |

|                      |            |        | Requirement |   |
|----------------------|------------|--------|-------------|---|
| Leverage             | \$ 100,120 | 8.50 % | 5.0         | % |
| Common Equity Tier 1 | \$ 100,120 | 12.38% | 6.5         | % |
| Tier 1 Risk-Based    | \$ 100,120 | 12.38% | 8.0         | % |
| Total Risk-Based     | \$ 110,256 | 13.64% | 10.0        | % |

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In July 2013, the Federal Reserve Board and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations and to conform this framework to the Basel Committee's current international regulatory capital accord (Basel III). These rules replaced the federal banking agencies' general risk-based capital rules, advanced approaches rule, market-risk rule, and leverage rules, in accordance with certain transition provisions. The Bank became subject to the new rules on January 1, 2015. The new rules implement higher minimum capital requirements, include a new common equity Tier 1 capital requirement, and establish criteria that instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. When fully phased in, the final rules will provide for increased minimum capital ratios as follows: (a) a common equity Tier 1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (which is an increase from 4.0%); (c) a total capital ratio of 8%; and (d) a Tier 1 leverage ratio to average consolidated assets of 4%. Under the new rules, in order to avoid certain limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk-based capital requirements (equal to 2.5% of total risk-weighted assets). The phase-in of the capital conservation buffer began on January 1, 2016, and will be completed by January 1, 2019. The new rules also provide for various adjustments and deductions to the definitions of regulatory capital that will phase in through December 31, 2017.

### 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, 2017, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016, which are incorporated by reference herein.

### ITEM 4. – CONTROLS AND PROCEDURES

(a) We maintain "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) have concluded that the design and operation of our disclosure controls and procedures are effective as of September 30, 2017. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended September 30, 2017, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II – OTHER INFORMATION

### ITEM 1. – LEGAL PROCEEDINGS

Neither the Company nor the Bank is a party to any material pending legal proceeding, nor is any of their property the subject of any material pending legal proceeding, except ordinary routine litigation arising in the ordinary course of the Bank's business and incidental to its business, none of which is expected to have a material adverse impact upon the Company's or the Bank's business, financial position or results of operations.

### ITEM 1A. – RISK FACTORS

For a discussion of risk factors relating to our business, please refer to Part I, Item 1A of our 2016 Form 10-K, which is incorporated by reference herein, and to the following:

#### The Bank's Dependence on Real Estate Lending Increases Our Risk of Losses

At September 30, 2017, approximately 75% of the Bank's loans in principal amount (excluding loans held-for-sale) were secured by real estate. The value of the Bank's real estate collateral has been, and could in the future continue to be, adversely affected by the economic recession and resulting adverse impact on the real estate market in Northern California.

The Bank's primary lending focus has historically been commercial (including agricultural), construction, and real estate mortgage. At September 30, 2017, real estate mortgage (excluding loans held-for-sale) and construction loans (residential and other) comprised approximately 70% and 4%, respectively, of the total loans in the Bank's portfolio. At September 30, 2017, all of the Bank's real estate mortgage and construction loans and approximately 15% of its commercial loans were secured fully or in part by deeds of trust on underlying real estate. The Company's dependence on real estate increases the risk of loss in both the Bank's loan portfolio and its holdings of other real estate owned if economic conditions in Northern California deteriorate in the future. California markets have experienced a strong recovery in home prices since the housing market crisis; however, home price growth has begun to moderate and some fundamentals of the housing market have remained soft through the recovery. A renewed downturn and deterioration of the real estate market in Northern California would have a material adverse effect on the Company's business, financial condition, and results of operations.

The CFPB has adopted various regulations which have impacted, and will continue to impact, our residential mortgage lending business. For additional information, see "Business – Certain CFPB Rules" in Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2016.

Adverse economic factors affecting certain industries the Bank serves could adversely affect our business.

We are subject to certain industry specific economic factors. For example, a portion of the Bank's total loan portfolio is related to residential and commercial real estate, especially in California. Increases in residential mortgage loan interest rates could have an adverse effect on the Bank's operations by depressing new mortgage loan originations, which in turn could negatively impact the Bank's title and escrow deposit levels. Additionally, a further downturn in the residential real estate and housing industries in California could have an adverse effect on the Bank's operations and the quality of its real estate and construction loan portfolio. Although the Bank does not engage in subprime or negative amortization lending, effects of recent subprime market challenges, combined with the ongoing challenges in the U.S. and California real estate markets, could result in further price reductions in single family home prices and a lack of liquidity in refinancing markets. These factors could adversely impact the quality of the Bank's residential construction, residential mortgage and construction related commercial portfolios in various ways, including by decreasing the value of the collateral for our loans. These factors could also negatively affect the economy in general and thereby the Bank's overall loan portfolio.

The Bank provides financing to, and receives deposits from, businesses in a number of other industries that may be particularly vulnerable to industry-specific economic factors, including the home building, commercial real estate, retail, agricultural, industrial, and commercial industries. The home building industry in California has been especially adversely impacted by the deterioration in residential real estate markets, which has lead the Bank to take additional provisions and charge-offs against credit losses in this portfolio. Continued increases in fuel prices and energy costs and the continuation of the drought in California could adversely affect businesses in several of these industries. Recent wildfires across California and in our market area have resulted in significant damage and destruction of property and equipment. The fire damage caused may result in adverse economic impacts to those affected markets and beyond. Industry specific risks are beyond the Bank's control and could adversely affect the Bank's portfolio of loans, potentially resulting in an increase in non-performing loans or charge-offs and a slowing of growth or reduction in our loan portfolio.

#### Adverse California Economic Conditions Could Adversely Affect the Bank's Business

The Bank's operations and a substantial majority of the Bank's assets and deposits are generated and concentrated primarily in Northern California, particularly the counties of Placer, Sacramento, Solano and Yolo, and are likely to remain so for the foreseeable future. At September 30, 2017, approximately 75% of the Bank's loan portfolio in principal amount (excluding loans held-for-sale) consisted of real estate-related loans, all of which were secured by collateral located in Northern California. As a result, a downturn in the economic conditions in Northern California may cause the Bank to incur losses associated with high default rates and decreased collateral values in its loan portfolio. Economic conditions in California are subject to various uncertainties including deterioration in the California real estate market and housing industry.

At times, economic conditions in California, and especially the regional markets we serve, have been subject to various challenges, including significant deterioration in the residential real estate sector and the California state government's budgetary and fiscal difficulties. While California home prices and the California economy in general have experienced a recovery in recent years, there can be no assurance that the recovery will continue. Recent growth in home prices in some California markets may be unsustainable relative to market fundamentals, and home price declines may occur.

In addition, until 2013, the State government of California experienced budget shortfalls or deficits that led to protracted negotiations between the Governor and the State Legislature over how to address the budget gap. The California electorate approved, in the 2012 general elections, certain increases in the rate of income taxation in California. However, there can be no assurance that the state's fiscal and budgetary challenges will not recur. In addition, the impact of increased rates of income taxation on the level of economic activity in California cannot be predicted at this time.

Also, municipalities and other governmental units within California have been experiencing budgetary difficulties, and several California municipalities have filed for protection under the Bankruptcy Code. As a result, concerns also have arisen regarding the outlook for the State of California's governmental obligations, as well as those of California municipalities and other governmental units.

Poor economic conditions in California, and especially the regional markets we serve, will cause us to incur losses associated with higher default rates and decreased collateral values in our loan portfolio. If the budgetary and fiscal difficulties of the California State government and California municipalities and other governmental units were to recur or economic conditions in California decline, we expect that our level of problem assets will increase and our prospects for growth will be impaired.



Potential Volatility of Deposits May Increase Our Cost of Funds

At September 30, 2017 and December 31, 2016, 2% and 1% of the dollar value of the Company's total deposits was represented by time certificates of deposit in excess of \$250,000, respectively. Although we have adopted a pricing strategy designed to reduce the level of time deposits, these deposits are also considered volatile and could be subject to withdrawal. Withdrawal of a material amount of such deposits could adversely impact the Company's liquidity, profitability, business prospects, results of operations and cash flows.

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

None.

ITEM 3. – DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. – MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. – OTHER INFORMATION

None.

ITEM 6. – EXHIBITS

| Exhibit<br>Number | Description of Document |
|-------------------|-------------------------|
|-------------------|-------------------------|

|              |  |
|--------------|--|
| <u>10.26</u> | Amended and Restated Executive Deferral Plan of First Northern Bank effective July 20, 2017. |
|--------------|--|

|              |   |
|--------------|---|
| <u>10.27</u> | Executive Retirement/Retention Participation Agreement for Joe Danelson, Executive Vice President and Chief Credit Officer. |
|--------------|---|

|              |  |
|--------------|--|
| <u>10.28</u> | Executive Retirement/Retention Participation Agreement for Jeremiah Z. Smith, Senior Executive Vice President and Chief Financial Officer & Chief Operating Officer. |
|--------------|--|

|             |   |
|-------------|---|
| <u>31.1</u> | Rule 13a — 14(a) Certification of Chief Executive Officer |
|-------------|---|

|             |   |
|-------------|---|
| <u>31.2</u> | Rule 13a — 14(a) Certification of Chief Financial Officer |
|-------------|---|

|              |   |
|--------------|---|
| <u>32.1*</u> | Statement of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350) |
|--------------|---|

|              |   |
|--------------|---|
| <u>32.2*</u> | Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350) |
|--------------|---|

|     |   |
|-----|---|
| 101 | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2017, is formatted in XBRL interactive data files: (i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Comprehensive (Loss) Income; (iv) Condensed Consolidated Statement of Stockholders' Equity; (v) Condensed Consolidated Statements of Cash Flows; and (vi) Notes to Condensed Consolidated Financial Statements. |
|-----|---|

\* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed "filed" for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act.



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 1,  
2017

By: /s/ Jeremiah Z. Smith

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