

FIRST NORTHERN COMMUNITY BANCORP  
Form 10-Q  
August 12, 2010

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

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FORM 10-Q

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

For the Quarterly Period Ended June 30, 2010

OR

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

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

Commission File Number 000-30707

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

California  
(State or other jurisdiction of incorporation or  
organization)

68-0450397  
(I.R.S. Employer Identification Number)

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

95620  
(Zip Code)

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

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

Yes  No

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

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

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

Accelerated filer   
Smaller reporting company

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

Yes  No

The number of shares of Common Stock outstanding as of August 11, 2010 was 9,065,416.

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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)   | June 30,<br>2010<br>(unaudited) | December<br>31,<br>2009 |
|--|---------------------------------|-------------------------|
| <b>Assets</b>  |                                 |                         |
| Cash and due from banks  | \$157,172                       | \$147,076               |
| Investment securities – available-for-sale   | 79,010                          | 75,868                  |
| Loans, net of allowance for loan losses of \$12,030 at June 30, 2010<br>and \$11,916 at December 31, 2009  | 452,429                         | 474,378                 |
| Loans held-for-sale  | 1,513                           | 1,640                   |
| Stock in Federal Home Loan Bank and other equity securities, at cost   | 2,822                           | 2,506                   |
| Premises and equipment, net  | 6,983                           | 7,397                   |
| Other Real Estate Owned  | 2,483                           | 3,518                   |
| Accrued interest receivable and other assets   | 33,757                          | 35,242                  |
| <b>Total Assets</b>  | <b>\$736,169</b>                | <b>\$747,625</b>        |
| <b>Liabilities and Stockholders' Equity</b>  |                                 |                         |
| <b>Liabilities:</b>  |                                 |                         |
| Demand deposits  | \$173,838                       | \$179,684               |
| Interest-bearing transaction deposits  | 139,818                         | 133,224                 |
| Savings and MMDA's   | 196,234                         | 186,456                 |
| Time, under \$100,000  | 48,866                          | 55,013                  |
| Time, \$100,000 and over   | 82,112                          | 97,049                  |
| <b>Total deposits</b>  | <b>640,868</b>                  | <b>651,426</b>          |
| FHLB Advances and other borrowings   | 9,835                           | 11,813                  |
| Accrued interest payable and other liabilities   | 6,273                           | 6,293                   |
| <b>Total liabilities</b>   | <b>656,976</b>                  | <b>669,532</b>          |
| <b>Stockholders' Equity:</b>   |                                 |                         |
| Preferred stock, par value \$0.01 per share; \$1,000 per share liquidation<br>preference, 18,500 shares authorized; 17,390 shares issued and<br>outstanding at June 30, 2010 and December 31, 2009 | 16,882                          | 16,822                  |
| Common stock, no par value; 16,000,000 shares authorized;<br>9,065,416 shares issued and outstanding at June 30, 2010 and  |                                 |                         |

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|  |           |           |
|--|-----------|-----------|
| 9,055,137 shares issued and outstanding at December 31, 2009 | 62,591    | 62,457    |
| Additional paid in capital                                   | 977       | 977       |
| Accumulated deficit  | (1,609 )  | (2,074 )  |
| Accumulated other comprehensive income/(loss), net           | 352       | (89 )     |
| Total stockholders' equity                                   | 79,193    | 78,093    |
| <br>   |           |           |
| Total Liabilities and Stockholders' Equity                   | \$736,169 | \$747,625 |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

| (in thousands, except per share amounts)                  | Three<br>months<br>ended<br>June 30,<br>2010 | Three<br>months<br>ended<br>June 30,<br>2009 | Six months<br>ended<br>June 30,<br>2010 | Six months<br>ended<br>June 30,<br>2009 |
|---|--|--|---|---|
| <b>Interest and Dividend Income:</b>                      |  |  |   |   |
| Loans   | \$6,764                                      | \$7,833                                      | \$13,562                                | \$15,770                                |
| Federal funds sold  | —  | 20   | —                                       | 39                                      |
| Due from banks interest bearing accounts                  | 88   | 29   | 182                                     | 60                                      |
| Investment securities                                     |  |  |   |   |
| Taxable   | 407  | 273  | 782                                     | 467                                     |
| Non-taxable   | 206  | 256  | 441                                     | 518                                     |
| Other earning assets                                      | 3  | 6  | 3                                       | 6                                       |
| Total interest and dividend income                        | 7,468  | 8,417  | 14,970                                  | 16,860                                  |
| <b>Interest Expense:</b>                                  |  |  |   |   |
| Deposits  | 862  | 1,071  | 1,866                                   | 2,133                                   |
| Other borrowings  | 108  | 123  | 215                                     | 281                                     |
| Total interest expense                                    | 970  | 1,194  | 2,081                                   | 2,414                                   |
| Net interest income                                       | 6,498  | 7,223  | 12,889                                  | 14,446                                  |
| Provision for loan losses                                 | 863  | 1,161  | 2,313                                   | 2,267                                   |
| Net interest income after provision<br>for loan losses    | 5,635  | 6,062  | 10,576                                  | 12,179                                  |
| <b>Other operating income:</b>                            |  |  |   |   |
| Service charges on deposit accounts                       | 842  | 881  | 1,667                                   | 1,744                                   |
| Gains on other real estate owned                          | 17   | 2  | 44                                      | 4                                       |
| Gains on sales of loans held-for-sale                     | 179  | 400  | 296                                     | 574                                     |
| Investment and brokerage services income                  | 247  | 174  | 491                                     | 323                                     |
| Mortgage brokerage income                                 | 2  | 28   | 10                                      | 43                                      |
| Loan servicing income                                     | 107  | 263  | 379                                     | 359                                     |
| Fiduciary activities income                               | 72   | 58   | 142                                     | 156                                     |
| ATM fees  | 72   | 64   | 134                                     | 122                                     |
| Signature based transaction fees                          | 201  | 164  | 374                                     | 303                                     |
| Gains (loss) on sales of available-for-sale<br>securities | 353  | 264  | 353                                     | 264                                     |
| Other income  | 237  | 169  | 442                                     | 315                                     |
| Total other operating income                              | 2,329  | 2,467  | 4,332                                   | 4,207                                   |
| <b>Other operating expenses:</b>                          |  |  |   |   |
| Salaries and employee benefits                            | 3,790  | 4,006  | 7,558                                   | 7,654                                   |
| Occupancy and equipment                                   | 810  | 940  | 1,658                                   | 1,938                                   |
| Data processing   | 408  | 442  | 856                                     | 889                                     |
| Stationery and supplies                                   | 77   | 96   | 158                                     | 219                                     |
| Advertising   | 145  | 152  | 276                                     | 313                                     |
| Directors' fees   | 54   | 51   | 106                                     | 103                                     |
| Other real estate owned expense and write-downs           | 214  | 605  | 444                                     | 1,329                                   |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Other expense                               | 1,969    | 1,826    | 3,284    | 3,341    |
| Total other operating expenses              | 7,467    | 8,118    | 14,340   | 15,786   |
| Income before benefit for income taxes      | 497      | 411      | 568      | 600      |
| Benefit for income taxes                    | (102 )   | (165 )   | (392 )   | (429 )   |
| Net income                                  | \$599    | \$576    | \$960    | \$1,029  |
| Preferred stock dividends and accretion     | \$(249 ) | \$(244 ) | \$(495 ) | \$(295 ) |
| Net income available to common shareholders | \$350    | \$332    | \$465    | \$734    |
| Basic income per share                      | \$0.04   | \$0.04   | \$0.05   | \$0.08   |
| Diluted income per share                    | \$0.04   | \$0.04   | \$0.05   | \$0.08   |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except share amounts)

|  | Preferred Stock |          | Common Stock |          | Comprehensive Income | Additional Paid-in Capital | (Accumulated Deficit) | Accumulated Other Comprehensive Income (Loss) | Total    |
|--|-----------------|----------|--------------|----------|----------------------|----------------------------|-----------------------|---|----------|
|  | Shares          | Amounts  | Shares       | Amounts  |                      |                            |                       |   |          |
| Balance at December 31, 2009   | 17,390          | \$16,822 | 9,055,137    | \$62,457 |                      | \$ 977                     | \$ (2,074 )           | \$ (89 )                                      | \$78,093 |
| Comprehensive income:  |                 |          |              |          |                      |                            |                       |   |          |
| Net income   |                 |          |              |          | \$ 960               |                            | 960                   |   | 960      |
| Other comprehensive income, net of tax:  |                 |          |              |          |                      |                            |                       |   |          |
| Unrealized holding gains on securities arising during the current period, net of tax effect of \$437 |                 |          |              |          | 653                  |                            |                       |   |          |
| Reclassification adjustment due to gains realized on sales of securities, net of tax effect of \$141 |                 |          |              |          | (212 )               |                            |                       |   |          |
| Total other comprehensive income, net of tax effect of \$296   |                 |          |              |          | 441                  |                            |                       | 441   | 499      |



|  |        |          |           |          |  |        |             |        |        |          |
|--|--------|----------|-----------|----------|--|--------|-------------|--------|--------|----------|
| Comprehensive income   |        |          |           |          |  |        |             |        |        | \$ 1,401 |
| Issuance of preferred stock  |        | —        |           |          |  |        |             |        |        |          |
| Dividend on preferred stock  |        |          |           |          |  |        |             |        | (435 ) | (435 )   |
| Discount accretion on preferred stock                                |        | 60       |           |          |  |        |             |        | (60 )  | —        |
| Stock-based compensation and related tax benefits                    |        |          |           |          |  |        |             | 134    |        | 134      |
| Common shares issued, stock options exercised, net of swapped shares |        |          |           |          |  |        |             | 10,279 |        |          |
| Balance at June 30, 2010   | 17,390 | \$16,882 | 9,065,416 | \$62,591 |  | \$ 977 | \$ (1,609 ) | \$ 352 |        | \$79,193 |

See notes to unaudited condensed consolidated financial statements.

## FIRST NORTHERN COMMUNITY BANCORP

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

|   | (in thousands)                       |                                      |
|---|--------------------------------------|--------------------------------------|
|   | Six months<br>ended June<br>30, 2010 | Six months<br>ended June<br>30, 2009 |
| <b>Cash Flows From Operating Activities</b>                                       |                                      |                                      |
| Net Income  | \$960                                | \$1,029                              |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |                                      |
| Depreciation and amortization   | 409                                  | 482                                  |
| Provision for loan losses   | 2,313                                | 2,267                                |
| Stock plan accruals   | 134                                  | 186                                  |
| Tax benefit for stock options   |                                      | 10                                   |
| Gains on sales of available-for-sale securities                                   | (353 )                               | (264 )                               |
| Gains on sales of other real estate owned   | (44 )                                | (4 )                                 |
| Write-downs on other real estate owned  | 304                                  | 1,200                                |
| Gains on sales of loans held-for-sale   | (296 )                               | (574 )                               |
| Proceeds from sales of loans held-for-sale  | 19,993                               | 70,665                               |
| Originations of loans held-for-sale   | (19,570 )                            | (71,675 )                            |
| Changes in assets and liabilities:  |                                      |                                      |
| Decrease in accrued interest receivable and other assets                          | 1,189                                | 837                                  |
| (Decrease) increase in accrued interest payable and other liabilities             | (20 )                                | 510                                  |
| Net cash provided by operating activities   | 5,019                                | 4,669                                |
| <b>Cash Flows From Investing Activities</b>                                       |                                      |                                      |
| Net increase in investment securities   | (2,052 )                             | (11,273 )                            |
| Net decrease in loans   | 18,695                               | 27,851                               |
| Net increase in other interest earning assets                                     | (316 )                               | (195 )                               |
| Proceeds from the sale of other real estate owned                                 | 1,716                                | —                                    |
| Purchases (sales) of premises and equipment, net                                  | 5                                    | (432 )                               |
| Net cash provided by investing activities   | 18,048                               | 15,951                               |
| <b>Cash Flows From Financing Activities</b>                                       |                                      |                                      |
| Net (decrease) increase in deposits   | (10,558 )                            | 31,900                               |
| Proceeds from issuance of preferred stock   | —                                    | 16,726                               |
| Proceeds from issuance of common stock warrants                                   | —                                    | 664                                  |
| Net decrease in FHLB advances and other borrowings                                | (1,978 )                             | (6,144 )                             |
| Cash dividends paid on preferred stock  | (435 )                               | (261 )                               |
| Cash dividends paid   | —                                    | (5 )                                 |
| Tax benefit for stock options   | —                                    | (10 )                                |
| Net cash (used) in provided by financing activities                               | (12,971 )                            | 43,870                               |
| Net Increase in Cash and Cash Equivalents   | 10,096                               | 63,490                               |
| Cash and Cash Equivalents, beginning of period                                    | 147,076                              | 66,010                               |
| Cash and Cash Equivalents, end of period  | \$157,172                            | \$129,500                            |

## Supplemental Disclosures of Cash Flow Information:

## Cash paid during the period for:

|              |         |         |
|--------------|---------|---------|
| Interest     | \$2,156 | \$2,451 |
| Income Taxes | \$152   | \$401   |

## Supplemental disclosures of non-cash investing and financing activities:

|  |       |          |
|--|-------|----------|
| Preferred stock dividend payable and accretion                     | \$171 | \$295    |
| Transfer of loans held-for-investment to other real estate owned   | \$975 | —        |
| Stock dividend distributed   | —     | \$2,249  |
| Unrealized holding gains (losses) on available for sale securities | \$441 | \$(376 ) |

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2010 and 2009 and December 31, 2009

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of First Northern Community Bancorp (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Articles 9 and 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for any interim period are not necessarily indicative of results expected for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission. The preparation of financial statements in conformity with GAAP also requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. All material intercompany balances and transactions have been eliminated in consolidation.

Recently Issued Accounting Pronouncements:

In June 2009, the Financial Accounting Standards Board (FASB) amended FASB Accounting Standards Codification (ASC) Topic 860, “Transfers and Servicing.” The new authoritative accounting guidance amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a “qualifying special-purpose entity” and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The Company adopted the new authoritative accounting guidance under ASC Topic 860 on January 1, 2010. Adoption of the new guidance did not significantly impact the Company’s financial statements.

In January 2010, FASB amended FASB ASC Topic 820, “Fair Value Measurements and Disclosures.” This amendment requires disclosures about significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers, and requires the reconciliation of activity in Level 3 fair value measurements be made on a gross basis. The amendment also clarifies the level of disaggregation required in disclosures and the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for Level 2 or Level 3 items. The part of the amendment related to the reconciliation of Level 3 activity is effective for interim and annual periods beginning after December 15, 2010. The remaining parts of the amendment are effective for interim and annual periods beginning after December 15, 2009. The Company adopted the remaining parts of the amendment on January 1, 2010. Adoption of the new guidance did not significantly impact the Company’s financial statements. The Company does not expect the adoption of the part of the amendment related to the reconciliation of Level 3 activity to have a significant impact on its financial statements.

In July 2010, FASB amended FASB ASC Topic 310, “Receivables.” This amendment modifies the disclosures that an entity provides about the credit quality of its financing receivables and the related allowance for credit losses. As a

result of these amendments, an entity is required to disaggregate, by portfolio segment or class of financing receivable, certain existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses. The disclosures are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The Company does not expect the adoption of this amendment to have a significant impact on its financial statements.

## Reclassifications

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

## 2. ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at levels considered adequate by management to provide for loan losses that can be reasonably anticipated. The allowance is based on management's assessment of various factors affecting the loan portfolio, including problem loans, economic conditions and loan loss experience, and an overall evaluation of the quality of the underlying collateral. See discussion on page 35 "Asset Quality" regarding impaired/problem loans.

Changes in the allowance for loan losses during the six month periods ended June 30, 2010 and 2009 and for the year ended December 31, 2009 were as follows:

|                              | (in thousands)                       |          |                                       |
|------------------------------|--------------------------------------|----------|---------------------------------------|
|                              | Six months ended<br>June 30,<br>2010 | 2009     | Year ended<br>December<br>31,<br>2009 |
| Balance, beginning of period | \$11,916                             | \$14,435 | \$14,435                              |
| Provision for loan losses    | 2,313                                | 2,267    | 10,489                                |
| Loan charge-offs             | (2,736 )                             | (3,267 ) | (14,293 )                             |
| Loan recoveries              | 537                                  | 742      | 1,285                                 |
| Balance, end of period       | \$12,030                             | \$14,177 | \$11,916                              |

Impaired loans are loans for which it is probable that the Company will not be able to collect all amounts due. Non-performing impaired loans totaled approximately \$14,700 and \$17,614 at June 30, 2010 and December 31, 2009, respectively, and had related valuation allowances of approximately \$287 and \$130 at June 30, 2010 and December 31, 2009, respectively. The average outstanding balance of non-performing impaired loans was approximately \$16,608 and \$15,064 for the periods ended June 30, 2010 and December 31, 2009, respectively. Performing impaired loans are restructured loans in compliance with modified terms and totaled \$7,832 and \$9,984 at June 30, 2010 and December 31, 2009, respectively, and had related valuation allowances of approximately \$991 and \$707 at June 30, 2010 and December 31, 2009, respectively. The average outstanding balance of performing impaired loans was approximately \$7,021 and \$6,216 for the years ended June 30, 2010 and December 31, 2009, respectively.

3.

## MORTGAGE OPERATIONS

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

The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold. The Company sold substantially its entire portfolio of conforming long-term residential mortgage loans originated during the six months ended June 30, 2010 for cash proceeds equal to the fair value of the loans.

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

At June 30, 2010, the Company had \$1,513,000 of mortgage loans held-for-sale. At June 30, 2010 and December 31, 2009, the Company serviced real estate mortgage loans for others of \$198,799,000 and \$189,025,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of June 30, 2010 and December 31, 2009.

|   | (in thousands)       |           |            |                  |
|---|----------------------|-----------|------------|------------------|
|   | December<br>31, 2009 | Additions | Reductions | June 30,<br>2010 |
| Mortgage servicing rights                             | \$1,550              | \$195     | \$177      | \$1,568          |
| Valuation allowance                                   | (277 )               | —         | (116 )     | (161 )           |
| Mortgage servicing rights, net of valuation allowance | \$1,273              | \$195     | \$61       | \$1,407          |

## 4. OUTSTANDING SHARES AND EARNINGS PER SHARE

## Earnings Per Share (EPS)

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

The following table presents a reconciliation of basic and diluted EPS for the three-month and six-month periods ended June 30, 2010 and 2009

|   | (in thousands, except share and earnings) |           |                              |           |
|---|---|-----------|------------------------------|-----------|
|   | Three months ended<br>June 30,            |           | Six months ended<br>June 30, |           |
|   | 2010                                      | 2009      | 2010                         | 2009      |
| Basic earnings per share:                           |   |           |                              |           |
| Net income  | \$599                                     | \$576     | \$960                        | \$1,029   |
| Preferred stock dividend and accretion              | \$(249 )                                  | \$(244 )  | \$(495 )                     | \$(295 )  |
| Net income available to common shareholders         | \$350                                     | \$332     | \$465                        | \$734     |
| Weighted average common shares outstanding          | 9,020,354                                 | 8,973,645 | 9,014,661                    | 8,966,467 |
| Basic EPS   | \$0.04                                    | \$0.04    | \$0.05                       | \$0.08    |
| Diluted earnings per share:                         |   |           |                              |           |
| Net income  | \$599                                     | \$576     | \$960                        | \$1,029   |
| Preferred stock dividend and accretion              | \$(249 )                                  | \$(244 )  | \$(495 )                     | \$(295 )  |
| Net income available to common shareholders         | \$350                                     | \$332     | \$465                        | \$734     |
| Weighted average common shares outstanding          | 9,020,354                                 | 8,973,645 | 9,014,661                    | 8,966,467 |
| Effect of dilutive options                          | 3,525                                     | 7,174     | 2,148                        | 26,184    |
| Adjusted weighted average common shares outstanding | 9,023,879                                 | 8,980,819 | 9,016,809                    | 8,992,651 |
| Diluted EPS   | \$0.04                                    | \$0.04    | \$0.05                       | \$0.08    |

Options not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 499,687 shares and 424,954 shares for the three months ended June 30, 2010 and 2009 respectively. In addition, 352,977 warrants issued to the U.S. Treasury were not used in the computation of diluted earnings per share because they would have had an anti-dilutive effect.

Options not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 499,687 shares and 424,954 shares for the six months ended June 30, 2010 and 2009 respectively. In addition, 352,977 warrants issued to the U.S. Treasury were not used in the computation of diluted earnings per share because they would have had an anti-dilutive effect.





## 5. STOCK PLANS

The following table presents the activity related to stock options for the three months ended June 30, 2010.

|  | Number 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 | 525,187             | \$ 11.13                                 |                                 |   |
| Granted                                    | —                   | —  |                                 |   |
| Expired                                    | —                   | —  |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  | —                               |   |
| Options outstanding at End of Period       | 525,187             | \$ 11.13                                 | \$5,650                         | 3.83  |
| Exercisable (vested) at End of Period      | 485,995             | \$ 11.24                                 | \$ 100                          | 3.46  |

The following table presents the activity related to stock options for the six months ended June 30, 2010.

|  | Number 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 | 514,807             | \$ 11.27                                 |                                 |   |
| Granted                                    | 17,500              | 4.25                                     |                                 |   |
| Expired                                    | (7,120 )            | 3.88                                     |                                 |   |
| Cancelled / Forfeited                      | —                   | —  |                                 |   |
| Exercised                                  | —                   | —  | —                               |   |
| Options outstanding at End of Period       | 525,187             | \$ 11.13                                 | \$5,650                         | 3.83  |
| Exercisable (vested) at End of Period      | 485,995             | \$ 11.24                                 | \$ 100                          | 3.46  |

The weighted average fair value of options granted during the six-month period ended June 30, 2010 was \$1.89 per share.

As of June 30, 2010, there was \$89,000 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 2.07 years.

There was \$44,000 of recognized compensation cost related to non-vested stock options for the six months ended June 30, 2010.

A summary of the weighted average assumptions used in valuing stock options during the three months and six months ended June 30, 2010 is presented below:

|                           | Three Months Ended<br>June 30, 2010* | Six months Ended<br>June 30, 2010 |
|---------------------------|--------------------------------------|-----------------------------------|
| Risk Free Interest Rate   | —                                    | 2.44%                             |
| Expected Dividend Yield   | —                                    | 0.00%                             |
| Expected Life in Years    | —                                    | 5                                 |
| Expected Price Volatility | —                                    | 48.12%                            |

\* There were no stock options or restricted stock granted during the three-month period ended June 30, 2010.

The following table presents the activity related to restricted stock for the three months ended June 30, 2010.

|  | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate<br>Intrinsic<br>Value | Weighted Average<br>Remaining Contractual<br>Term<br>(in years) |
|--|---------------------|---|---------------------------------|---|
| Options outstanding at Beginning of Period | 47,647              | \$10.93   |                                 |   |
| Granted                                    | —                   | —   |                                 |   |
| Cancelled / Forfeited                      | (1,551 )            | \$8.07  |                                 |   |
| Exercised/Released/Vested                  | —                   | —   | —                               |   |
| Options outstanding at End of Period       | 46,096              | \$11.02   | \$209,737                       | 8.16  |

The following table presents the activity related to restricted stock for the six months ended June 30, 2010.

|  | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value | Aggregate<br>Intrinsic<br>Value | Weighted Average<br>Remaining Contractual<br>Term<br>(in years) |
|--|---------------------|---|---------------------------------|---|
| Options outstanding at Beginning of Period | 35,817              | \$13.20   |                                 |   |
| Granted                                    | 12,050              | \$4.25  |                                 |   |
| Cancelled / Forfeited                      | (1,771 )            | \$8.91  |                                 |   |
| Exercised/Released/Vested                  | —                   | —   | —                               |   |
| Options outstanding at End of Period       | 46,096              | \$11.02   | \$209,737                       | 8.16  |

The weighted average fair value of options granted during the six-month period ended June 30, 2010 was \$4.25 per share.

As of June 30, 2010, there was \$198,000 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 2.14 years.

There was \$56,000 of recognized compensation cost related to non-vested stock options for the six months ended June 30, 2010.

The Company has an Employee Stock Purchase Plan (“ESPP”). Under the plan, the Company is authorized to issue to eligible employees shares of common stock. There are 292,136 shares authorized under the ESPP. The ESPP will terminate February 27, 2017. The ESPP is implemented by participation periods of not more than twenty-seven months each. The Board of Directors determines the commencement date and duration of each participation period. The Board of Directors approved the current participation period of November 24, 2009 to November 23, 2010. An eligible employee is one who has been continually employed for at least ninety (90) days prior to commencement of a participation period. Under the terms of the ESPP, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company’s common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair market value on the last trading day before the date of participation or the fair market value on the last trading day during the participation period.

As of June 30, 2010, there was \$30,500 of unrecognized compensation cost related to ESPP grants. This cost is expected to be recognized over a weighted average period of approximately 0.50 years.

There was \$30,500 of recognized compensation cost related to ESPP grants for the six-month period ended June 30, 2010.

The weighted average fair value at grant date during the six-month period ended June 30, 2010 was \$1.44.

A summary of the weighted average assumptions used in valuing ESPP grants during the three months and six months ended June 30, 2010 is presented below:

|                           | Three Months Ended<br>June 30, 2010 | Six Months Ended<br>June 30, 2010 |
|---------------------------|-------------------------------------|-----------------------------------|
| Risk Free Interest Rate   | 0.29%                               | 0.29%                             |
| Expected Dividend Yield   | 0.00%                               | 0.00%                             |
| Expected Life in Years    | 1.00                                | 1.00                              |
| Expected Price Volatility | 30.00%                              | 30.00%                            |

## 6. EXECUTIVE SALARY CONTINUATION PLAN

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

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

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

|   | Three months ended June |          |
|---|-------------------------|----------|
|   | 2010                    | 2009     |
| Components of Net Periodic Benefit Cost |                         |          |
| Service Cost                            | \$27,726                | \$3,990  |
| Interest Cost                           | 30,551                  | 26,418   |
| Amortization of Plan Gain               | (3,748 )                | (8,180 ) |
| Amortization of prior service cost      | 21,821                  | 21,821   |
| Net periodic benefit cost               | \$76,350                | \$44,049 |

The Company estimates that the annual net periodic benefit cost will be \$305,398 for the year ended December 31, 2010. This compares to an annual net periodic benefit cost of \$238,312 for the year ended December 31, 2009.

## Estimated Contributions for Fiscal 2010

For unfunded plans, contributions to the Executive Salary Continuation Plan are the benefit payments made to participants. At December 31, 2009 the Company expected to make benefit payments of \$54,144 in connection with the Executive Salary Continuation Plan during fiscal 2010.

## 7. DIRECTORS' RETIREMENT PLAN

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

|   | Three months ended June |          |
|---|-------------------------|----------|
|   | 2010                    | 2009     |
| Components of Net Periodic Benefit Cost |                         |          |
| Service Cost                            | \$8,836                 | \$11,088 |
| Interest Cost                           | 8,267                   | 7,921    |
| Net periodic benefit cost               | \$17,103                | \$19,009 |

The Company estimates that the annual net periodic benefit cost will be \$68,950 for the year ended December 31, 2010. This compares to annual net periodic benefit costs of \$76,034 for the year ended December 31, 2009.

## Estimated Contributions for Fiscal 2010

For unfunded plans, contributions to the Directors' Retirement Plan are the benefit payments made to participants. At December 31, 2009 the Company expected to make cash contributions of \$15,000 to the Directors' Retirement Plan during fiscal 2010.



## 8. FAIR VALUE MEASUREMENT

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale, trading securities and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a non-recurring basis, such as loans held-for-sale, loans held-for-investment and certain other assets. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

### Fair Value Hierarchy

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

Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models, and similar techniques and include management judgment and estimation which may be significant.

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

### Investment Securities Available-for-Sale

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

### Loans Held-for-Sale

Loans held-for-sale are carried at the lower of cost or market value. The fair value of loans held-for-sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies loans subjected to non-recurring fair value adjustments as Level 2. At June 30, 2010 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. 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 June 30, 2010, substantially all of the total impaired loans were evaluated based on the fair value of the underlying collateral securing the loan. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as non-recurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as non-recurring Level 3.

#### Other Real Estate Owned

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

#### Loan Servicing Rights

Loan servicing rights are subject to impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used in the completion of impairment testing. If the valuation model reflects a value less than the carrying value, loan servicing rights are adjusted to fair value through a valuation allowance as determined by the model. As such, the Company classifies loan servicing rights subjected to non-recurring fair value adjustments as Level 3.

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

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of June 30, 2010.

| June 30, 2010   | (in thousands) |          |          |         |
|---|----------------|----------|----------|---------|
|   | Total          | Level 1  | Level 2  | Level 3 |
| U.S. Treasury securities                                | \$251          | \$251    | \$—      | \$—     |
| Securities of U.S. government agencies and corporations | 27,609         | 27,609   | —        | —       |
| Obligations of states and political subdivisions        | 16,603         | —        | 16,603   | —       |
| Mortgage-backed securities                              | 34,547         | —        | 34,547   | —       |
| Total investments at fair value                         | \$79,010       | \$27,860 | \$51,150 | \$—     |

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2009.

| December 31, 2009                                       | (in thousands) |         |         |         |
|---|----------------|---------|---------|---------|
|   | Total          | Level 1 | Level 2 | Level 3 |
| U.S. Treasury securities                                | \$253          | \$253   | \$—     | \$—     |
| Securities of U.S. government agencies and corporations | 4,335          | 4,335   | —       | —       |

|  |          |         |          |     |
|--|----------|---------|----------|-----|
| Obligations of states and political subdivisions | 23,416   | —       | 23,416   | —   |
| Mortgage-backed securities                       | 47,864   | —       | 47,864   | —   |
| Total investments at fair value                  | \$75,868 | \$4,588 | \$71,280 | \$— |

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

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

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of June 30, 2010.

|                                   | (in thousands) |            |            |                | Total             |
|-----------------------------------|----------------|------------|------------|----------------|-------------------|
| June 30, 2010                     | Total          | Level 1    | Level 2    | Level 3        | gains/losses      |
| Impaired loans                    | \$4,068        | \$—        | \$—        | \$4,068        | \$(1,220 )        |
| Other real estate owned           | 521            | —          | —          | 521            | (400 )            |
| Loan servicing rights             | 1,407          | —          | —          | 1,407          | 378               |
| <b>Total assets at fair value</b> | <b>\$5,996</b> | <b>\$—</b> | <b>\$—</b> | <b>\$5,996</b> | <b>\$(1,242 )</b> |

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, 2009.

|                                   | (in thousands)  |            |            |                 | Total             |
|-----------------------------------|-----------------|------------|------------|-----------------|-------------------|
| December 31, 2009                 | Total           | Level 1    | Level 2    | Level 3         | gains/losses      |
| Impaired loans                    | \$9,207         | \$—        | \$—        | \$9,207         | \$(6,422 )        |
| Other real estate owned           | 3,518           | —          | —          | 3,518           | (1,545 )          |
| Loan servicing rights             | 1,273           | —          | —          | 1,273           | 779               |
| <b>Total assets at fair value</b> | <b>\$13,998</b> | <b>\$—</b> | <b>\$—</b> | <b>\$13,998</b> | <b>\$(7,188 )</b> |

## 9. PREFERRED STOCK AND COMMON STOCK WARRANTS

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

## 10. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

### Cash and Cash Equivalents

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

### Investment Securities

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

### Federal Home Loan Bank and Other Equity Securities

The carrying amounts reported in the balance sheet approximate fair value.

### Loans Receivable

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

interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest receivable approximates its fair value.

#### Commitments to Extend Credit and Standby Letters of Credit

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

#### Deposit Liabilities

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

#### FHLB Advances and Other Borrowings

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



## Limitations

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

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

The estimated fair values of the Company's financial instruments for the period ended June 30, 2010 and December 31, 2009 are approximately as follows:

| (in thousands)                     | June 30, 2010   |            | December 31, 2009 |            |
|------------------------------------|-----------------|------------|-------------------|------------|
|                                    | Carrying amount | Fair value | Carrying amount   | Fair value |
| <b>Financial assets:</b>           |                 |            |                   |            |
| Cash and federal funds sold        | \$157,172       | \$157,172  | \$147,076         | \$147,076  |
| Investment securities              | 79,010          | 79,010     | 75,868            | 75,868     |
| Other equity securities            | 2,822           | 2,822      | 2,506             | 2,506      |
| <b>Loans:</b>                      |                 |            |                   |            |
| Net loans                          | 452,429         | 453,402    | 474,378           | 476,485    |
| Loans held-for-sale                | 1,513           | 1,562      | 1,640             | 1,652      |
| <b>Financial liabilities:</b>      |                 |            |                   |            |
| Deposits                           | 640,868         | 624,041    | 651,426           | 632,322    |
| FHLB advances and other borrowings | 9,835           | 10,100     | 11,813            | 12,260     |

| (in thousands)                             | June 30, 2009   |            | December 31, 2009 |            |
|--|-----------------|------------|-------------------|------------|
|  | Contract amount | Fair value | Contract amount   | Fair value |
| <b>Unrecognized financial instruments:</b> |                 |            |                   |            |
| Commitments to extend credit               | \$161,556       | \$1,212    | \$191,589         | \$1,437    |
| Standby letters of credit                  | 3,888           | 39         | 3,572             | 36         |

## 11. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated market values of investments in debt and other securities at June 30, 2010 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>market<br>value |
|---|-------------------|---------------------|----------------------|------------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                              |
| U.S. Treasury securities                                | \$250             | \$1                 | \$—                  | \$251                        |
| Securities of U.S. government agencies and corporations | 27,432            | 177                 | —                    | 27,609                       |
| Obligations of states and political subdivisions        | 16,492            | 227                 | (116 )               | 16,603                       |
| Mortgage-backed securities                              | 33,948            | 606                 | (7 )                 | 34,547                       |
| Total debt securities                                   | \$78,122          | \$1,011             | \$(123 )             | \$79,010                     |

The amortized cost, unrealized gains and losses and estimated market values of investments in debt and other securities at December 31, 2009 are summarized as follows:

| (in thousands)  | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Estimated<br>market<br>value |
|---|-------------------|---------------------|----------------------|------------------------------|
| Investment securities available-for-sale:               |                   |                     |                      |                              |
| U.S. Treasury securities                                | \$253             | \$—                 | \$—                  | \$253                        |
| Securities of U.S. government agencies and corporations | 4,353             | —                   | (18 )                | 4,335                        |
| Obligations of states and political subdivisions        | 23,374            | 308                 | (266 )               | 23,416                       |
| Mortgage-backed securities                              | 47,737            | 213                 | (86 )                | 47,864                       |
| Total debt securities                                   | \$75,717          | \$521               | \$(370 )             | \$75,868                     |

Gross realized gains from sales of available-for-sale securities were \$353 for the six months ended June 30, 2010 and \$454 for the year ended December 31, 2009. Gross realized losses from sales of available-for-sale securities were \$9 for the six months ended June 30, 2010 and \$0 for the year ended December 31, 2009.

The amortized cost and estimated market value of debt and other securities at June 30, 2010, by contractual maturity, are shown in the following table:

| (in thousands)                         | Amortized<br>cost | Estimated<br>market<br>value |
|--|-------------------|------------------------------|
| Due in one year or less                | \$27,197          | \$27,345                     |
| Due after one year through five years  | 37,318            | 37,990                       |
| Due after five years through ten years | 2,344             | 2,374                        |
| Due after ten years                    | 11,263            | 11,301                       |

\$78,122      \$79,010

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities due after one year through five years included mortgage-backed securities totaling \$34,477. The maturities on these securities were based on the average lives of the securities.

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An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of June 30, 2010, follows:

| (in thousands)  | Less than 12 months<br>Fair Value | Unrealized<br>losses | 12 months or more<br>Fair Value | Unrealized<br>losses | Total<br>Fair Value | Total<br>Unrealized<br>losses |
|---|-----------------------------------|----------------------|---------------------------------|----------------------|---------------------|-------------------------------|
| Securities of U.S.<br>government agencies<br>and corporations | —                                 | —                    | —                               | —                    | —                   | —                             |
| Obligations of states and<br>political subdivisions           | 3,605                             | (55 )                | 1,385                           | (61 )                | 4,990               | (116 )                        |
| Mortgage-backed securities                                    | 2,094                             | (7 )                 | —                               | —                    | 2,094               | (7 )                          |
| <b>Total</b>  | <b>\$5,699</b>                    | <b>\$(62 )</b>       | <b>\$1,385</b>                  | <b>\$(61 )</b>       | <b>\$7,084</b>      | <b>\$(123 )</b>               |

No decline in value was considered “other-than-temporary” during 2010. Nine securities that had a fair market value of \$5,699 and a total unrealized loss of \$62 have been in an unrealized loss position for less than twelve months as of June 30, 2010. In addition, five securities with a fair market value of \$1,385 and a total unrealized loss of \$61 have been in an unrealized loss position for more than twelve months as of June 30, 2010. As the Company does not intend to sell these securities and it is not more likely than not that we will be required to sell these securities, 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, 2009, follows:

| (in thousands)  | Less than 12 months<br>Fair Value | Unrealized<br>losses | 12 months or more<br>Fair Value | Unrealized<br>losses | Total<br>Fair Value | Total<br>Unrealized<br>losses |
|---|-----------------------------------|----------------------|---------------------------------|----------------------|---------------------|-------------------------------|
| Securities of U.S.<br>government agencies<br>and corporations | 3,332                             | (18 )                | —                               | —                    | 3,332               | (18 )                         |
| Obligations of states and<br>political subdivisions           | 5,624                             | (154 )               | 951                             | (112 )               | 6,575               | (266 )                        |
| Mortgage-backed securities                                    | 16,290                            | (86 )                | —                               | —                    | 16,290              | (86 )                         |
| <b>Total</b>  | <b>\$25,246</b>                   | <b>\$(258 )</b>      | <b>\$951</b>                    | <b>\$(112 )</b>      | <b>\$26,197</b>     | <b>\$(370 )</b>               |

No decline in value was considered “other-than-temporary” during 2009. Thirty-five securities that had a fair market value of \$25,246 and a total unrealized loss of \$258 have been in an unrealized loss position for less than twelve

months as of December 31, 2009. In addition, three securities with a fair market value of \$951 and a total unrealized loss of \$112 that have been in an unrealized loss position for more than twelve months as of December 31, 2009. As the Company does not intend to sell these securities and it is not more likely than not that we will be required to sell these securities, these investments are not considered other-than-temporarily impaired.

Investment securities carried at \$31,811 and \$29,194 at June 30, 2010 and December 31, 2009, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

FIRST NORTHERN COMMUNITY BANCORP

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

FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements, which 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 2009 Annual Report on Form 10-K for factors to be considered when reading any forward-looking statements in this filing.

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

In this document, for example we make forward-looking statements relating to the following topics:

- Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position
  - Credit quality and provision for credit losses
- Our allowances for credit losses, including the conditions we consider in determining the unallocated allowance and our portfolio credit quality, underwriting standards, and risk grade
  - 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 legislation and governmental measures enacted or introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy
  - Regulatory controls and processes and their impact on our business
    - The costs and effects of legal actions
    - Our regulatory capital requirements
  - We do not anticipate paying a cash dividend in the foreseeable future

- Our assessment of economic conditions and trends and credit cycles and their impact on our business
  - The impact of changes in interest rates and our strategy to manage our interest rate risk profile
- Loan portfolio composition and risk grade trends, expected charge offs, delinquency rates and our underwriting standards

- Recent increases in deposits and movements from time deposits to savings and money market accounts
- The Company believes that the Bank's deposit base does not involve any undue concentration levels from one or a few major depositors
  - Our intent to sell, and the likelihood that we would be required to sell, various investment securities
    - Our liquidity position
- Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or change in accounting principles
  - Expected rates of return, yields and projected results

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, Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I of this Form 10-Q, and "Supervision and Regulation" of our 2009 Annual Report on Form 10-K.



## INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this Report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire Report, together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2009.

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

Significant results and developments during the second quarter and year-to-date 2010 include:

- Net income of \$0.96 million for the six months ended June 30, 2010, down 6.8% from the \$1.03 million for the same fiscal period last year.
- Diluted income per share for the six months ended June 30, 2010 was \$0.05, down 37.5% from the diluted income per share of \$0.08 reported in the same period last year (per share data has been adjusted for stock dividends).
- Net interest income decreased in the six months ended June 30, 2010 by \$1.5 million, or 10.8%, to \$12.9 million from \$14.4 million in the same period last year. The decrease in net interest income was primarily attributable to a decrease in interest yields, which was partially offset by a decrease in interest costs. Net interest margin decreased from 4.77% for the six-month period ending June 30, 2009 to 3.77% for the same period ending June 30, 2010.
- Provision for loan losses of \$2.3 million for the six-month periods ended June 30, 2010 and June 30, 2009.
- Total assets at June 30, 2010 were \$736.2 million, an increase of \$21.2 million, or 3.0%, from levels at June 30, 2009.
- Total net loans at June 30, 2010 (including loans held-for-sale) decreased \$36.7 million, or 7.5%, to \$453.9 million compared to June 30, 2009.
- Total investment securities at June 30, 2010 increased \$26.0 million, or 49.0%, to \$79.0 million compared to June 30, 2009.
- Total deposits of \$640.9 million at June 30, 2010, represented an increase of \$24.3 million, or 3.9%, compared to June 30, 2009. We believe a primary reason for the increase in deposits during this period was depositor movement from troubled financial institutions and the stock market to institutions of perceived greater safety and the Company's standing in the communities it serves. Since the peak in the real estate market, deposits in the real estate related business accounts have shown consistent reduction in average and end of period balances while the number of customers has remained stable.
- Net income for the quarter of \$0.60 million, up 3.5% from the \$0.58 million earned in the second quarter of 2009.
- Diluted earnings per share of \$0.04 for the quarters ended June 30, 2010 and June 30, 2009.



## SUMMARY

The Company recorded net income of \$960,000 for the six-month period ended June 30, 2010, representing a decrease of \$69,000 from net income of \$1,029,000 for the same period in 2009.

The following table presents a summary of the results for the three-month and six-month periods ended June 30, 2010 and 2009.

(in thousands, except per share amounts and ratios)

|  | Three<br>months<br>ended<br>June<br>30, 2010 | Three<br>months<br>ended<br>June<br>30, 2009 | Six months<br>ended<br>June 30,<br>2010 | Six months<br>ended<br>June<br>30, 2009 |
|--|--|--|---|---|
|--|--|--|---|---|

For the Period:

|                                    |        |        |        |         |
|------------------------------------|--------|--------|--------|---------|
| Net Income                         | \$599  | \$576  | \$960  | \$1,029 |
| Basic Earnings Per Common Share*   | \$0.04 | \$0.04 | \$0.05 | \$0.08  |
| Diluted Earnings Per Common Share* | \$0.04 | \$0.04 | \$0.05 | \$0.08  |

At Period End:

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Total Assets                                     | \$736,227 | \$715,041 | \$736,227 | \$715,041 |
| Total Loans, Net (including loans held-for-sale) | \$453,942 | \$490,626 | \$453,942 | \$490,626 |
| Total Investment Securities                      | \$79,010  | \$53,016  | \$79,010  | \$53,016  |
| Total Deposits                                   | \$640,868 | \$616,618 | \$640,868 | \$616,618 |
| Loan-To-Deposit Ratio                            | 70.83     | % 79.57   | % 70.83   | % 79.57   |

\*Adjusted for stock dividends

## FIRST NORTHERN COMMUNITY BANCORP

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

|   | Three months ended<br>June 30, 2010 |          |                | Three months ended<br>June 30, 2009 |           |                | Yield/<br>Rate |   |
|---|-------------------------------------|----------|----------------|-------------------------------------|-----------|----------------|----------------|---|
|   | Average<br>Balance                  | Interest | Yield/<br>Rate | Average<br>Balance                  | Interest  | Yield/<br>Rate |                |   |
| <b>Assets</b>   |                                     |          |                |                                     |           |                |                |   |
| Interest-earning assets:                              |                                     |          |                |                                     |           |                |                |   |
| Loans (1)   | \$454,520                           | \$6,764  | 5.97           | %                                   | \$491,107 | \$7,833        | 6.40           | % |
| Federal funds sold                                    | —                                   | —        | —              |                                     | 71,472    | 20             | 0.11           | % |
| Interest bearing due from banks                       | 139,951                             | 88       | 0.25           | %                                   | 2,525     | 29             | 4.61           | % |
| Investment securities, taxable                        | 71,083                              | 407      | 2.30           | %                                   | 30,729    | 273            | 3.56           | % |
| Investment securities,<br>non-taxable (2)             | 19,903                              | 206      | 4.15           | %                                   | 24,318    | 256            | 4.22           | % |
| Other interest earning assets                         | 2,725                               | 3        | 0.44           | %                                   | 2,446     | 6              | 0.98           | % |
| Total interest-earning assets                         | 688,182                             | 7,468    | 4.35           | %                                   | 622,597   | 8,417          | 5.42           | % |
| Non-interest-earning assets:                          |                                     |          |                |                                     |           |                |                |   |
| Cash and due from banks                               | 13,820                              |          |                |                                     | 40,147    |                |                |   |
| Premises and equipment, net                           | 7,106                               |          |                |                                     | 7,687     |                |                |   |
| Other real estate owned                               | 3,437                               |          |                |                                     | 3,444     |                |                |   |
| Accrued interest receivable and<br>other assets       | 33,802                              |          |                |                                     | 27,015    |                |                |   |
| Total average assets                                  | 746,347                             |          |                |                                     | 700,890   |                |                |   |
| <b>Liabilities and Stockholders' Equity:</b>          |                                     |          |                |                                     |           |                |                |   |
| Interest-bearing liabilities:                         |                                     |          |                |                                     |           |                |                |   |
| Interest-bearing transaction                          |                                     |          |                |                                     |           |                |                |   |
| deposits  | 138,824                             | 98       | 0.28           | %                                   | 128,915   | 156            | 0.49           | % |
| Savings and MMDA's                                    | 194,426                             | 301      | 0.62           | %                                   | 163,460   | 306            | 0.75           | % |
| Time, under \$100,000                                 | 50,489                              | 96       | 0.76           | %                                   | 55,847    | 183            | 1.31           | % |
| Time, \$100,000 and over                              | 87,519                              | 367      | 1.68           | %                                   | 84,078    | 426            | 2.03           | % |
| FHLB advances and other<br>borrowings                 | 11,841                              | 108      | 3.66           | %                                   | 13,680    | 123            | 3.61           | % |
| Total interest-bearing liabilities                    | 483,099                             | 970      | 0.80           | %                                   | 445,980   | 1,194          | 1.07           | % |
| Non-interest-bearing liabilities:                     |                                     |          |                |                                     |           |                |                |   |
| Non-interest-bearing demand<br>deposits               | 179,165                             |          |                |                                     | 170,063   |                |                |   |
| Accrued interest payable and<br>other liabilities     | 6,109                               |          |                |                                     | 6,064     |                |                |   |
| Total liabilities                                     | 668,373                             |          |                |                                     | 622,107   |                |                |   |
| Total stockholders' equity                            | 77,974                              |          |                |                                     | 78,783    |                |                |   |
| Total average liabilities and<br>stockholders' equity | \$746,347                           |          |                |                                     | \$700,890 |                |                |   |
| Net interest income and net<br>interest margin (3)    |                                     | \$6,498  | 3.79           | %                                   |           | \$7,223        | 4.65           | % |

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 \$228 and \$567 for the three months ended June 30, 2010 and 2009, respectively.
2. Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.
3. Net interest margin is computed by dividing net interest income by total average interest-earning assets.

## FIRST NORTHERN COMMUNITY BANCORP

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

|   | Six months ended<br>June 30, 2010 |          |                | Six months ended<br>June 30, 2009 |           |                | Yield/<br>Rate |   |
|---|-----------------------------------|----------|----------------|-----------------------------------|-----------|----------------|----------------|---|
|   | Average<br>Balance                | Interest | Yield/<br>Rate | Average<br>Balance                | Interest  | Yield/<br>Rate |                |   |
| Assets  |                                   |          |                |                                   |           |                |                |   |
| Interest-earning assets:                              |                                   |          |                |                                   |           |                |                |   |
| Loans (1)   | \$458,218                         | \$13,562 | 5.97           | %                                 | \$494,726 | \$15,770       | 6.43           | % |
| Federal funds sold                                    | —                                 | —        | —              |                                   | 62,781    | 39             | 0.13           | % |
| Interest bearing due from banks                       | 142,273                           | 182      | 0.26           | %                                 | 2,513     | 60             | 4.81           | % |
| Investment securities, taxable                        | 65,799                            | 782      | 2.40           | %                                 | 23,998    | 467            | 3.92           | % |
| Investment securities,<br>non-taxable (2)             | 21,257                            | 441      | 4.18           | %                                 | 24,663    | 518            | 4.24           | % |
| Other interest earning assets                         | 2,616                             | 3        | 0.23           | %                                 | 2,379     | 6              | 0.51           | % |
| Total interest-earning assets                         | 690,163                           | 14,970   | 4.37           | %                                 | 611,060   | 16,860         | 5.56           | % |
| Non-interest-earning assets:                          |                                   |          |                |                                   |           |                |                |   |
| Cash and due from banks                               | 14,047                            |          |                |                                   | 39,667    |                |                |   |
| Premises and equipment, net                           | 7,222                             |          |                |                                   | 8,024     |                |                |   |
| Other real estate owned                               | 3,545                             |          |                |                                   | 3,889     |                |                |   |
| Accrued interest receivable and<br>other assets       | 34,004                            |          |                |                                   | 26,861    |                |                |   |
| Total average assets                                  | 748,981                           |          |                |                                   | 689,501   |                |                |   |
| Liabilities and Stockholders' Equity:                 |                                   |          |                |                                   |           |                |                |   |
| Interest-bearing liabilities:                         |                                   |          |                |                                   |           |                |                |   |
| Interest-bearing transaction deposits                 |                                   |          |                |                                   |           |                |                |   |
|   | 137,410                           | 212      | 0.31           | %                                 | 126,518   | 332            | 0.53           | % |
| Savings and MMDA's                                    | 194,236                           | 645      | 0.67           | %                                 | 163,432   | 589            | 0.73           | % |
| Time, under \$100,000                                 | 51,843                            | 255      | 0.99           | %                                 | 57,355    | 423            | 1.49           | % |
| Time, \$100,000 and over                              | 91,284                            | 754      | 1.67           | %                                 | 77,551    | 789            | 2.05           | % |
| FHLB advances and other borrowings                    | 11,820                            | 215      | 3.67           | %                                 | 15,502    | 281            | 3.66           | % |
| Total interest-bearing liabilities                    | 486,593                           | 2,081    | 0.86           | %                                 | 440,358   | 2,414          | 1.11           | % |
| Non-interest-bearing liabilities:                     |                                   |          |                |                                   |           |                |                |   |
| Non-interest-bearing demand deposits                  |                                   |          |                |                                   |           |                |                |   |
|   | 178,647                           |          |                |                                   | 172,279   |                |                |   |
| Accrued interest payable and<br>other liabilities     | 6,123                             |          |                |                                   | 5,997     |                |                |   |
| Total liabilities                                     | 671,363                           |          |                |                                   | 618,634   |                |                |   |
| Total stockholders' equity                            | 77,618                            |          |                |                                   | 70,867    |                |                |   |
| Total average liabilities and<br>stockholders' equity | \$748,981                         |          |                |                                   | \$689,501 |                |                |   |
| Net interest income and net<br>interest margin (3)    |                                   | \$12,889 | 3.77           | %                                 |           | \$14,446       | 4.77           | % |

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 \$450 and \$1,057 for the six months ended June 30, 2010 and 2009, respectively.
2. Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.
3. Net interest margin is computed by dividing net interest income by total average interest-earning assets.

## CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a \$10,096,000 increase in cash and due from banks, a \$3,142,000 increase in investment securities available-for-sale, a \$21,949,000 decrease in net loans held-for-investment, a \$127,000 decrease in loans held-for-sale, a \$1,035,000 decrease in other real estate owned and a \$1,427,000 decrease in accrued interest receivable and other assets from December 31, 2009 to June 30, 2010. The increase in cash and due from banks was due to increases in both non-interest and interest bearing due from bank accounts. The increase in investment securities available-for-sale was primarily the result of purchases of agency bonds and was slightly offset by sales of mortgage-backed securities and municipal securities. Management evaluated the unrealized loss associated with the investment securities available-for-sale and no decline was considered “other than temporary” at June 30, 2010. As the Company does not intend to sell these securities and it is not more likely than not that we will be required to sell these securities, these investments are not considered other-than-temporarily impaired. The decrease in loans held-for-investment was due to decreases in the following loan categories: commercial and industrial; agricultural; equipment; financed equipment leases; true equipment leases; consumer; real estate; real estate commercial and construction; and real estate SBA (Small Business Administration), which were partially offset by increases in home equity loans. The decrease in loans held-for-sale was in real estate loans and was due, primarily, to a decrease in the origination of loans. The Company originated approximately \$19,866,000 in residential mortgage loans during the first six months of 2010, which was offset by approximately \$19,993,000 in loan sales during this period. The decrease in other real estate owned was due to sales of OREO properties, which was slightly offset by an addition of OREO property. The decrease in accrued interest receivable and other assets was mainly due to decreases in housing tax credits, accrued income taxes receivable, unamortized cost on loans, prepaid expenses and suspense items, which was partially offset by increases in accrued income on loans, accrued income on securities, cash surrender value of bank owned life insurance and mortgage servicing asset.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a decrease in total deposits of \$10,558,000 at June 30, 2010 compared to December 31, 2009. The decrease in deposits was due to decreases in demand and time deposits, which was partially offset by increases in interest-bearing transaction deposits, savings and money market accounts. The decrease in demand deposit accounts is due in large part to the impact of the slowing real estate activity in the communities served by the Company. Since the peak in the real estate market, deposits in the real estate related business accounts have shown consistent reduction in average and end of period balances while the number of customers has remained stable. The decrease in time deposits and increase in savings and money market accounts are primarily due to maturities of time deposits and transfers of those funds to savings and money market accounts.

Federal Home Loan Bank advances (“FHLB advances”) and other borrowings decreased \$1,978,000 for the six months ended June 30, 2010 compared to the year ended December 31, 2009, primarily due to maturing FHLB advances.



## CHANGES IN RESULTS OF OPERATIONS

### Interest Income

The Federal Open Market Committee made no changes to the Federal Funds rate during the twelve-month period ended June 30, 2010.

Interest income on loans for the six-month period ended June 30, 2010 was down 14.0% from the same period in 2009, decreasing from \$15,770,000 to \$13,562,000 and was down 13.7% for the three-month period ended June 30, 2010 over the same period in 2009, from \$7,833,000 to \$6,764,000. The decrease in interest income on loans for the six-month period ended as compared to the same period a year ago was primarily due to a 46 basis point decrease in loan yields combined with a decrease in average loans. The decrease for the three-month period ended June 30, 2010 as compared to the same period a year ago was primarily due to a 43 basis point decrease in loan yields combined with a decrease in average loans.

Interest income on investment securities available-for-sale for the six-month period ended June 30, 2010 was up 24.2% from the same period in 2009, increasing from \$985,000 to \$1,223,000 and was up 15.9% for the three-month period ended June 30, 2010 over the same period in 2009, from \$529,000 to \$613,000. The increase in interest income on investment securities for the six-month period ended June 30, 2010 as compared to the same period a year ago was primarily due to an increase in average investment securities partially offset by a 125 basis point decrease in investment securities yields. The increase for the three-month period ended June 30, 2010 as compared to the same period a year ago was primarily due to an increase in average investment securities partially offset by a 115 basis point decrease in investment securities yields.

Interest income on Federal Funds sold for the six-month period ended June 30, 2010 was down 100.0% from the same period in 2009, decreasing from \$39,000 to \$0 and was down 100% for the three-month period ended June 30, 2010 over the same period in 2009, from \$20,000 to \$0. The Company had no Federal Funds sold balances during the three-month and six-month periods ended June 30, 2010.

Interest income on interest-bearing due from banks for the six-month period ended June 30, 2010 was up 203.3% from the same period in 2009, increasing from \$60,000 to \$182,000 and was up 203.5% for the three-month period ended June 30, 2010 over the same period in 2009, from \$29,000 to \$88,000. The increase in interest income on interest-bearing due from banks for the six-month period ended June 30, 2010 as compared to the same period a year ago was primarily due to an increase in average interest-bearing due from banks partially offset by a 455 basis point decrease in interest-bearing due from banks yields. The increase for the three-month period ended June 30, 2010 as compared to the same period a year ago was primarily due to an increase in average interest-bearing due from banks, which was partially offset by a 436 basis point decrease in interest-bearing due from banks yield.

### Interest Expense

The decrease in general market interest rates decreased the Company's cost of funds in the first six months of 2010 compared to the same period a year ago.

Interest expense on deposits and other borrowings for the six-month period ended June 30, 2010 was down 13.8% from the same period in 2009, decreasing from \$2,414,000 to \$2,081,000 and was down 18.8% for the three-month period ended June 30, 2010 over the same period in 2009 from \$1,194,000 to \$970,000. The decrease in interest expense during the six-month period ended June 30, 2010 was primarily due to a 25 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The decrease in interest expense during the three-month period ended June 30, 2010 was primarily due to a 27 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities.

### Provision for Loan Losses

There was a provision for loan losses of \$2,313,000 for the six-month period ended June 30, 2010 compared to a provision for loan losses of \$2,267,000 for the same period in 2009. The allowance for loan losses was approximately \$12,030,000, or 2.59% of total loans, at June 30, 2010 compared to \$11,916,000, or 2.45% of total loans, at December 31, 2009. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

There was a provision for loan losses of \$863,000 for the three-month period ended June 30, 2010 compared to a \$1,161,000 provision for the same period in 2009.

The increase in the provision for loan losses during the six-month period in 2010 was primarily due to increased net charge-offs as a percentage of the allowance for loan losses, partially offset by decreased loan volumes compared to the six-month period in 2009. The decrease during the three-month period in 2010 was primarily due to stabilization in collateral values and repayment abilities of some of the Bank's customers combined with decreased loan volumes compared to the three-month period in 2009.

### Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the three-month and six-month periods ended June 30, 2010 and June 30, 2009.

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

## Other Operating Income

Other operating income was up 3.0% for the six-month period ended June 30, 2010 from the same period in 2009, increasing from \$4,207,000 to \$4,332,000.

This increase was primarily due to increases in gains on sales of other real estate owned, investment brokerage services income, signature based transaction fees, gains on sales of available-for-sale securities, and other miscellaneous income, which was partially offset by decreases in service charges on deposit accounts, gains on sales of loans held-for sale, and mortgage brokerage income. The increase in gains on sales of other real estate owned was due to an increased number of properties sold during the first half of 2010, compared to the first half of 2009. The increase in investment brokerage services income was due to an increase in the demand for those services. The increase in signature based transaction fees was primarily due to an increase in the volume of debit card transactions. The increase in gains on sales of available-for-sale securities was primarily due to an increased number of securities sold during the first half of 2010, compared to the first half of 2009. The increase in other miscellaneous income was primarily due to increases in standby letter of credit fees, check sales fees, gain on sale of equipment, and rental income on other real estate owned properties, which was partially offset by decreases in bankcard and merchant fees. The decrease in service charges on deposit accounts was primarily due to decreases in service charges on checking accounts, partially offset by increases in analysis service charges and decreases in waived fees. The decrease in gains on sales of loans held-for-sale was the result of decreased origination activity. The decrease in mortgage brokerage income was due to a decrease in the demand for those services.

Other operating income was down 5.6% for the three-month period ended June 30, 2010 from the same period in 2009, decreasing from \$2,467,000 to \$2,329,000.

This decrease was primarily due to decreases in service charges on deposit accounts, gains on sales of loans held-for-sale, mortgage brokerage income, and loan servicing income, which was partially offset by increases in investment and brokerage services income, signature based transaction fees, gains on sales of available-for-sale securities, and other miscellaneous income. The decrease in service charges on deposit accounts was primarily due to decreases in service charges on checking accounts, partially offset by increases in analysis service charges and decreases in waived fees. The decrease in gains on sales of loans held-for-sale was the result of decreased residential mortgage activity. The decrease in mortgage brokerage income was due to a decrease in the demand for those services. The decrease in loan servicing income is primarily due to a decrease in mortgage servicing assets recorded, partially offset by a decrease in mortgage servicing impairment expense. The increase in investment brokerage services income was due to an increase in the demand for those services. The increase in signature based transaction fees was primarily due to an increase in the volume of debit card transactions. The increase in gains on sales of available-for-sale securities was primarily due to an increased number of securities sold during the second quarter of 2010, compared to the second quarter of 2009. The increase in other miscellaneous income was primarily due to increases in standby letter of credit fees, check sales fees, gain on sale of equipment, and rental income on other real estate owned properties, which was partially offset by decreases in bankcard and merchant fees.

### Other Operating Expenses

Total other operating expenses was down 9.16% for the six-month period ended June 30, 2010 from the same period in 2009, decreasing from \$15,786,000 to \$14,340,000.

The decrease was primarily due to decreases in salaries and benefits, occupancy and equipment expense, data processing expense, other real estate owned expense, stationary and supplies, and other miscellaneous operating expense. The decrease in salaries and benefits was primarily due to decreases in regular salaries, commissions, stock compensation, and welfare and recreation, which was partially offset by loan origination costs, profit sharing retirement, compensation insurance, and retirement compensation expense. The decrease in occupancy and equipment was primarily due to decreases in rent expense, depreciation on furniture and equipment and computer hardware, equipment maintenance, and service contracts, which was partially offset by increases in building maintenance and hazard and liability insurance. The decrease in other real estate owned expense was due to lower write-downs and maintenance expenses related to OREO properties. The decrease in data processing was primarily due to a reduction in contract pricing, which was partially offset by an increase in general data processing costs. The decrease in stationary and supplies was primarily due to a reduction in the use of stationary and supplies. The decrease in other miscellaneous operating expense was primarily due to decreases in FDIC assessments, accounting and audit fees, and loan origination expense, which was partially offset by sundry losses and loan collection expense.

Total other operating expenses was down 8.02% for the three-month period ended June 30, 2010 from the same period in 2009, decreasing from \$8,118,000 to \$7,467,000.

The decrease was primarily due to decreases in salaries and benefits, occupancy and equipment expense, data processing, and other real estate owned expense, which was partially offset by an increase in other miscellaneous expense. The decrease in salaries and benefits was primarily due to decreases in regular salaries, commissions, loan origination costs, payroll taxes, welfare and recreation and stock compensation, which was partially offset by profit sharing retirement, compensation insurance, and retirement compensation expense. The decrease in occupancy and equipment was primarily due to decreases in rent expense, and depreciation on furniture and equipment and computer hardware, which was partially offset by an increase in utility costs and an increase in hazard and liability insurance. The decrease in data processing was primarily due to a reduction in contract pricing and general data processing costs. The decrease in other real estate owned expense was due to lower write-downs and maintenance expenses related to OREO properties. The increase in other miscellaneous expense was primarily due to increases in sundry losses and loan collection expense, which was partially offset by decreases in FDIC assessments and loan origination expense.

The following table sets forth other miscellaneous operating expenses by category for the three-month and six-month periods ended June 30, 2010 and 2009.

|   | (in thousands)                               |  |  |  |
|---|--|--|--|--|
|   | Three<br>months<br>ended<br>June 30,<br>2010 | Three<br>months<br>ended<br>June 30,<br>2009 | Six<br>months<br>ended<br>June 30,<br>2010 | Six<br>months<br>ended<br>June 30,<br>2009 |
| Other miscellaneous operating expenses              |  |  |  |  |
| FDIC assessments                                    | \$288  | \$536  | 573  | 752  |
| Contributions                                       | 25   | 19   | 50   | 39   |
| Legal fees  | 144  | 76   | 199  | 185  |
| Accounting and audit fees                           | 70   | 115  | 132  | 239  |
| Consulting fees                                     | 78   | 70   | 131  | 122  |
| Postage expense                                     | 107  | 91   | 194  | 188  |
| Telephone expense                                   | 51   | 81   | 113  | 149  |
| Public relations                                    | 40   | 71   | 77   | 109  |
| Training expense                                    | 21   | 25   | 43   | 45   |
| Loan origination expense                            | 54   | 206  | 147  | 467  |
| Computer software depreciation                      | 46   | 53   | 90   | 106  |
| Sundry losses                                       | 304  | 65   | 350  | 125  |
| Loan collection expense                             | 399  | 99   | 532  | 205  |
| Other miscellaneous expense                         | 342  | 319  | 653  | 610  |
| <b>Total other miscellaneous operating expenses</b> | <b>\$1,969</b>                               | <b>\$1,826</b>                               | <b>\$3,284</b>                             | <b>\$3,341</b>                             |

## Income Taxes

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

In the six months ended June 30, 2010, the Company's benefit for income taxes decreased \$37,000 from the same period last year, from a \$429,000 benefit to a benefit of \$392,000.

In the three months ended June 30, 2010, the Company's benefit for income taxes decreased \$63,000 from the same period last year, from a \$165,000 benefit to a benefit of \$102,000.

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

## Off-Balance Sheet Commitments

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

|                              | (in thousands)   |                      |
|------------------------------|------------------|----------------------|
|                              | June 30,<br>2010 | December<br>31, 2009 |
| Undisbursed loan commitments | \$ 161,556       | \$ 191,589           |
| Standby letters of credit    | 3,888            | 3,572                |
| Commitments to sell loans    | 6,090            | 3,179                |
|                              | \$ 171,534       | \$ 198,340           |

The reserve for unfunded lending commitments amounted to \$892,000 at June 30, 2010, which was unchanged from December 31, 2009. The reserve for unfunded lending commitments is included in other liabilities.

## Asset Quality

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

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

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

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

losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, the Company may pursue repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter, (generally every 3 – 6 months depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.



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

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

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

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

Classified assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased \$12,243,000 or 18.8% to \$52,878,000 at June 30, 2010 from \$65,121,000 at December 31, 2009.



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The following tables summarize the Company's non-accrual loans by loan category at June 30, 2010, March 31, 2010, and December 31, 2009.

|                          | At June 30, 2010 |            |           | At March 31, 2010 |            |           |
|--------------------------|------------------|------------|-----------|-------------------|------------|-----------|
|                          | Gross            | Guaranteed | Net       | Gross             | Guaranteed | Net       |
| (dollars in thousands)   |                  |            |           |                   |            |           |
| Residential mortgage     | \$ 1,494         | \$—        | \$ 1,494  | \$ 2,200          | \$—        | \$ 2,200  |
| Residential construction | 1,914            | —          | 1,914     | 2,051             | —          | 2,051     |
| Commercial real estate   | 7,002            | —          | 7,002     | 8,004             | —          | 8,004     |
| Agriculture              | 2,821            | —          | 2,821     | 2,821             | —          | 2,821     |
| Commercial               | 1,052            | 31         | 1,021     | 3,141             | 309        | 2,832     |
| Consumer                 | 364              | —          | 364       | 299               | —          | 299       |
| Total non-accrual loans  | \$ 14,647        | \$ 31      | \$ 14,616 | \$ 18,516         | \$ 309     | \$ 18,207 |

|                          | At December 31, 2009 |            |           |
|--------------------------|----------------------|------------|-----------|
|                          | Gross                | Guaranteed | Net       |
| (dollars in thousands)   |                      |            |           |
| Residential mortgage     | \$ 1,370             | \$—        | \$ 1,370  |
| Residential construction | 3,413                | —          | 3,413     |
| Commercial real estate   | 5,669                | —          | 5,669     |
| Agriculture              | 3,188                | —          | 3,188     |
| Commercial               | 3,875                | 408        | 3,467     |
| Consumer                 | 99                   | —          | 99        |
| Total non-accrual loans  | \$ 17,614            | \$ 408     | \$ 17,206 |

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 \$14,647,000 at June 30, 2010 and were comprised of six residential mortgage loans totaling \$1,494,000, nine residential construction loans totaling \$1,914,000, seven commercial real estate loans totaling \$7,002,000, two agricultural loans totaling \$2,821,000, nine commercial loans totaling \$1,052,000 and three consumer loans totaling \$364,000. Non-accrual loans amounted to \$17,614,000 at December 31, 2009 and were comprised of four residential mortgage loans totaling \$1,370,000, fifteen residential construction loans totaling \$3,413,000, seven commercial real estate loans totaling \$5,669,000, two agricultural loans totaling \$3,188,000, eight commercial loans totaling \$3,875,000 and one consumer loan totaling \$99,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan for which the Company does not expect to collect by writing the loan down to fair value.

The five largest non-accrual loans as of June 30, 2010, made up approximately 49.6% of total non-accrual loans and consisted of four commercial real estate loans totaling \$6,075,000, supported by commercial properties located with in

the Company's market area, one agricultural loan totaling \$2,403,000, supported by real property and the business assets of the company. All of the underlying collateral supporting these loans were appraised within the last six months.

In comparison, the five largest non-accrual loans as of December 31, 2009 made up approximately 53% of total non-accrual loans and consisted of one commercial and industrial loan totaling \$2,751,000, supported by the business assets of the company, one agricultural loan totaling \$2,403,000, supported by real property and the business assets of the company, two commercial real estate loans totaling \$3,308,000, supported by commercial properties located with in the Company's market area and one residential construction loan totaling \$1,460,000, supported by residential real estate.

Total non-performing impaired loans at June 30, 2010 and December 31, 2009 consisting of loans on non-accrual status totaled \$14,647,000 and \$17,614,000, respectively. Performing impaired loans consisting of loans restructured and in compliance with modified terms, totaled \$7,819,000 and \$9,984,000 at June 30, 2010 and December 31, 2009, respectively; the majority of the non-performing impaired loans were in management's opinion adequately collateralized based on recently obtained appraised property values or guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

The five largest non-performing loans as of June 30, 2010 consisting of loans on non-accrual and loans ninety days or more past due made up approximately 49.6% of total non-performing loans and consisted of four commercial real estate loans totaling \$6,075,000, supported by commercial properties located with in the Company's market area, one agricultural loan totaling \$2,403,000, supported by real property and the business assets of the company. All of the underlying collateral supporting these loans were appraised within the last six months.

In comparison, the five largest non-performing loans as of December 31, 2009 consisting of loans on non-accrual and loans ninety days or more past due made up approximately 53% of total non-performing loans and consisted of one commercial and industrial loan totaling \$2,751,000, supported by business assets of the company, one agricultural loan totaling \$2,403,000, supported by real property and the business assets of the company, two commercial real estate loans totaling \$3,308,000, supported by commercial properties located with in the Company's market area and one residential construction loan totaling \$1,460,000, supported by residential real estate.

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 \$3,617,000, or 17.5% to \$17,107,000 during the first six months of 2010. Non-performing assets net of guarantees represent 2.3% of total assets at June 30, 2010.

|   | At June 30, 2010 |            |          | At March 31, 2010 |            |          |
|---|------------------|------------|----------|-------------------|------------|----------|
|   | Gross            | Guaranteed | Net      | Gross             | Guaranteed | Net      |
| (dollars in thousands)                                      |                  |            |          |                   |            |          |
| Non-accrual loans   | \$14,647         | \$31       | \$14,616 | \$18,516          | \$309      | \$18,207 |
| Loans 90 days past due and still accruing                   | 54               | 46         | 8        | —                 | —          | —        |
| Total non-performing loans                                  | 14,701           | 77         | 14,624   | 18,516            | 309        | 18,207   |
| Other real estate owned                                     | 2,483            | —          | 2,483    | 4,262             | —          | 4,262    |
| Total non-performing assets                                 | 17,184           | 77         | 17,107   | 22,778            | 309        | 22,469   |
| Non-performing loans to total loans                         |                  |            | 3.15 %   |                   |            | 3.94 %   |
| Non-performing assets to total assets                       |                  |            | 2.32 %   |                   |            | 3.00 %   |
| Allowance for loan and lease losses to non-performing loans |                  |            | 82.31 %  |                   |            | 62.01 %  |

| At December 31, 2009 |            |     |
|----------------------|------------|-----|
| Gross                | Guaranteed | Net |

(dollars in thousands)

|   |          |       |          |   |
|---|----------|-------|----------|---|
| Non-accrual loans   | \$17,614 | \$408 | \$17,206 |   |
| Loans 90 days past due and still accruing                   | —        | —     | —        |   |
| Total non-performing loans                                  | 17,614   | 408   | 17,206   |   |
| Other real estate owned                                     | 3,518    | —     | 3,518    |   |
| Total non-performing assets                                 | 21,132   | 408   | 20,724   |   |
| Non-performing loans to total loans                         |          |       | 3.61     | % |
| Non-performing assets to total assets                       |          |       | 2.77     | % |
| Allowance for loan and lease losses to non-performing loans |          |       | 69.26    | % |

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The Company had loans 90 days past due and still accruing totaling \$54,000 and -0- at June 30, 2010 and December 31, 2009, respectively.

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

OREO amounted to \$2,483,000 and \$3,518,000 for the periods ended June 30, 2010 and December 31, 2009, respectively. The decrease in OREO at June 30, 2010 from the balance at December 31, 2009 was due, for the most part, to the disposition of seven OREO properties, which was partially offset by the addition of six OREO properties.

The Company had loans restructured and in compliance with modified terms totaling \$7,819,000 and \$9,984,000 at June 30, 2010 and December 31, 2009, respectively.

## Allowance for Loan Losses

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

The following table summarizes the loan loss experience of the Company for the six-month periods ended June 30, 2010 and 2009, and for the year ended December 31, 2009.

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

|  | Six months ended<br>June 30, |          | Year ended<br>December<br>31, |
|--|------------------------------|----------|-------------------------------|
|  | 2010                         | 2009     | 2009                          |
| Balance at beginning of period                   | \$11,916                     | \$14,435 | \$14,435                      |
| Provision for loan losses                        | 2,313                        | 2,267    | 10,489                        |
| Loans charged-off:                               |                              |          |                               |
| Commercial                                       | (1,064 )                     | (656 )   | (5,894 )                      |
| Agriculture                                      | (368 )                       | —        | (5,043 )                      |
| Real estate mortgage                             | (851 )                       | (712 )   | (272 )                        |
| Real estate construction                         | (356 )                       | (1,730 ) | (2,742 )                      |
| Consumer loans to individuals                    | (97 )                        | (169 )   | (342 )                        |
| Total charged-off                                | (2,736 )                     | (3,267 ) | (14,293 )                     |
| Recoveries:                                      |                              |          |                               |
| Commercial                                       | 434                          | 11       | 322                           |
| Agriculture                                      | —                            | —        | 5                             |
| Real estate mortgage                             | 3                            | —        | 2                             |
| Real estate construction                         | 8                            | 605      | 725                           |
| Consumer loans to individuals                    | 92                           | 126      | 231                           |
| Total recoveries                                 | 537                          | 742      | 1,285                         |
| Net charge-offs                                  | (2,199 )                     | (2,525 ) | (13,008 )                     |
| Balance at end of period                         | \$12,030                     | \$14,177 | \$11,916                      |
| Ratio of net charge-offs                         |                              |          |                               |
| To average loans outstanding during the period   | (0.47 %)                     | (0.50 %) | (2.65 %)                      |
| Allowance for loan losses                        |                              |          |                               |
| To total loans at the end of the period          | 2.59 %                       | 2.83 %   | 2.45 %                        |
| To non-performing loans at the end of the period | 82.17 %                      | 91.44 %  | 67.65 %                       |





## Deposits

Deposits are one of the Company's primary sources of funds. At June 30, 2010, the Company had the following deposit mix: 30.6% in savings and MMDA deposits, 20.5% in time deposits, 21.8% in interest-bearing transaction deposits and 27.31% in non-interest-bearing transaction deposits. Non-interest-bearing transaction deposits enhance the Company's net interest income by lowering its cost of funds.

The Company obtains deposits primarily from the communities it serves. 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 \$100,000 from customers. These deposits are priced to remain competitive.

Maturities of time certificates of deposits of \$100,000 or more outstanding at June 30, 2010 and December 31, 2009 are summarized as follows:

|                             | (in thousands)   |                      |
|-----------------------------|------------------|----------------------|
|                             | June 30,<br>2010 | December<br>31, 2009 |
| Three months or less        | \$32,578         | \$35,722             |
| Over three to twelve months | 36,766           | 47,616               |
| Over twelve months          | 12,768           | 13,711               |
| Total                       | \$82,112         | \$97,049             |

We believe the decrease in time certificates of deposit (CD's) of \$100,000 or more is primarily attributable to the maturities of time deposits and transfers of those funds to savings and money market accounts.

## 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 and in management's opinion the most common being the ratio of net loans to deposits (including loans held-for-sale). This ratio was 70.8% on June 30, 2010. In addition, on June 30, 2010, the Company had the following short-term investments: \$750,000 in Certificate of Deposit Account Registry Service ("CDARS"); \$3,004,000 in securities due within one year; and \$28,563,000 in securities due in one to five years.

To meet unanticipated funding requirements, the Company maintains short-term unsecured lines of credit with other banks totaling \$17,000,000 at June 30, 2010; additionally the Company has a line of credit with the Federal Home Loan Bank, with a current borrowing capacity of \$108,634,000.

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

As of June 30, 2010, the Bank's capital ratios exceeded applicable regulatory requirements. The following table presents the capital ratios for the Bank, compared to the standards for well-capitalized depository institutions, as of June 30, 2010.

(amounts in thousands except percentage amounts)

| Actual | Adequately |
|--------|------------|
|--------|------------|

|                   | Capital  | Ratio |   | Capitalized<br>Ratio |   | Well<br>Capitalized<br>Ratio<br>Requirement |   |
|-------------------|----------|-------|---|----------------------|---|---|---|
| Leverage          | \$69,639 | 9.43  | % | 4.0                  | % | 5.0   | % |
| Tier 1 Risk-Based | \$69,639 | 14.29 | % | 4.0                  | % | 6.0   | % |
| Total Risk-Based  | \$75,816 | 15.55 | % | 8.0                  | % | 10.0  | % |

### 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 June 30, 2010, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, which are incorporated by reference herein.

### ITEM 4. – CONTROLS AND PROCEDURES

(a) 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 June 30, 2010. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended June 30, 2010, 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

We are a party to various legal proceedings arising in the ordinary course of business, which we do not believe to be material to our business, financial condition or liquidity.

### ITEM 1A. – RISK FACTORS

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

#### Increased Regulation could Adversely Affect Us

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act enacts sweeping reforms to the U.S. financial regulatory system and will likely have a significant impact on financial services companies, including the Company. While many of the specific provisions of the Act still require implementation by various federal banking agencies and will not be immediately effective, it is expected that the Act will increase our cost of doing business in various ways, as will be the case for other insured depository institutions, and increase the regulatory complexity of our business. Some of the general provisions of the Act which we expect could have a direct impact on our business include the following:

- Creation of a federal consumer protection agency;
- Revisions to the federal deposit insurance program which could increase our insurance premiums;
- Changing the capital requirements of bank holding companies and banks;
- Allowing the payment of interest on business checking accounts; and

- Additional regulation of interchange fees on debit card transactions.

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 June 30, 2010, approximately [73]% of the Bank's loan portfolio (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 further 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 at this time, including the significant deterioration in the California real estate market and housing industry.

Governor Schwarzenegger declared a fiscal emergency on January 8, 2010, calling the State legislature into special session to begin taking action on the State's \$19.1 billion reported deficit. The State of California began its fiscal year on July 1, 2010 with the State legislature having failed to pass a budget to address the deficit. If an agreement is not reached soon, the State's financial situation would likely worsen, the State's credit ratings could further deteriorate and it may have to issue IOUs, halt infrastructure projects and reduce state worker pay, among other measures. The revised budget plan proposed by Governor Schwarzenegger for the 2010-2011 fiscal year includes \$12.4 billion in spending cuts to services and program eliminations, including to healthcare and social services programs. All three of the proposed budget plans before the State legislature assume that California will receive \$3.4 billion in federal assistance. However, there have been no assurances from the federal government that such funds will be furnished to California. If such funds are not awarded, California may be forced to further cut state services or raise taxes or fees.

The financial and economic consequences of this situation cannot be predicted with any certainty at this time. If economic conditions in California decline further it is expected that the Bank's level of problem assets would increase. California real estate is also subject to certain natural disasters, such as earthquakes, floods and mudslides, which are typically not covered by the standard hazard insurance policies maintained by borrowers. Uninsured disasters may make it difficult or impossible for borrowers to repay loans made by the Bank. The occurrence of natural disasters in California could have a material adverse effect on the Company's financial condition, results of operations, cash flows, and business prospects.

ITEM 6. – EXHIBITS

| Exhibit<br>Number | Exhibit   |
|-------------------|---|
| 3.1               | Amended and Restated Bylaws of First Northern Community Bancorp (the “Company”), incorporated herein by reference to Exhibit 3.1 of the Company’s Current Report on Form 8-K dated June 17, 2010. |
| 31.1              | Certification of the Company’s Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2              | Certification of the Company’s Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1              | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2              | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |

SIGNATURES

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

FIRST NORTHERN COMMUNITY BANCORP

Date: August 11, 2010      By: /s/ Louise A. Walker

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