

FIRST NORTHERN COMMUNITY BANCORP
Form 10-Q
November 07, 2013

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

FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2013

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Yes No

The number of shares of Common Stock outstanding as of November 7, 2013 was 9,478,300.

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 shares and share amounts)	September 30, 2013	December 31, 2012
Assets		
Cash and cash equivalents	\$ 149,944	\$ 161,359
Investment securities – available-for-sale	187,007	184,491
Loans, net of allowance for loan losses of \$8,792 at September 30, 2013 and \$8,554 at December 31, 2012	497,256	440,449
Loans held-for-sale	1,791	4,559
Stock in Federal Home Loan Bank and other equity securities, at cost	3,717	3,607
Premises and equipment, net	7,519	7,839
Other real estate owned	—	1,062
Interest receivable and other assets	28,786	28,117
Total Assets	\$876,020	\$831,483
Liabilities and Stockholders' Equity		
Liabilities:		
Demand deposits	\$258,352	\$230,743
Interest-bearing transaction deposits	199,303	184,900
Savings and MMDA's	237,342	223,078
Time, under \$100,000	34,011	35,617
Time, \$100,000 and over	54,506	56,473
Total deposits	783,514	730,811
Interest payable and other liabilities	8,849	8,347
Total Liabilities	792,363	739,158
Stockholders' Equity:		
Preferred stock, no par value; \$1,000 per share liquidation preference, 22,847 shares authorized; 12,847 shares issued and 12,847 shares outstanding at September 30, 2013 and 22,847 shares issued and outstanding at December 31, 2012	12,847	22,847
Common stock, no par value; 16,000,000 shares authorized; 9,478,300 shares issued and outstanding at September 30, 2013 and 9,272,668 shares issued and outstanding at December 31, 2012	64,460	63,410
Additional paid-in capital	977	977

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Retained earnings	6,510	3,917
Accumulated other comprehensive (loss) income, net	(1,137)	1,174
Total Stockholders' Equity	83,657	92,325
Total Liabilities and Stockholders' Equity	\$876,020	\$831,483

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
(in thousands, except per share amounts)				
Interest and dividend income:				
Loans	\$6,466	\$6,211	\$18,671	\$18,245
Due from banks interest bearing accounts	103	77	315	251
Investment securities				
Taxable	621	756	1,961	2,334
Non-taxable	99	103	298	310
Other earning assets	46	5	106	17
Total interest and dividend income	7,335	7,152	21,351	21,157
Interest expense:				
Deposits	306	375	952	1,305
Other borrowings	—	—	—	141
Total interest expense	306	375	952	1,446
Net interest income	7,029	6,777	20,399	19,711
Provision for loan losses	—	825	800	2,051
Net interest income after provision for loan losses	7,029	5,952	19,599	17,660
Other operating income:				
Service charges on deposit accounts	606	697	1,876	2,023
Gains on sales of other real estate owned	—	—	1	17
Gains on sales of loans held-for-sale	129	510	1,121	1,410
Investment and brokerage services income	295	258	958	761
Mortgage brokerage income	28	28	63	74
Loan servicing income	490	67	1,203	351
Fiduciary activities income	136	133	465	361
ATM fees	67	107	219	365
Signature based transaction fees	337	283	966	797
Gains on calls of available-for-sale securities	—	—	4	1
Other income	185	223	567	612
Total other operating income	2,273	2,306	7,443	6,772
Other operating expenses:				
Salaries and employee benefits	4,422	3,901	12,630	11,625
Occupancy and equipment	757	665	2,289	2,149
Data processing	414	400	1,258	1,220
Stationery and supplies	92	92	281	263
Advertising	76	69	263	273
Directors' fees	54	56	161	166
Other real estate owned (income) expense and impairment	(10)	3	11	63

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Other expense	1,120	1,284	3,637	3,729
Total other operating expenses	6,925	6,470	20,530	19,488
Income before income tax expense	2,377	1,788	6,512	4,944
Income tax expense	1,004	584	2,334	1,441
Net income	\$1,373	\$1,204	\$4,178	\$3,503
Preferred stock dividends	\$(162)	\$(286)	\$(534)	\$(857)
Net income available to common shareholders	\$1,211	\$918	\$3,644	\$2,646
Basic income per share	\$0.13	\$0.10	\$0.39	\$0.28
Diluted income per share	\$0.13	\$0.10	\$0.39	\$0.28

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Net income	\$1,373	\$1,204	\$4,178	\$3,503
Other comprehensive (loss) income, net of tax:				
Unrealized holding gains (losses) on securities:				
Unrealized holding gains (losses) arising during the period, net of tax effect of \$93 and \$295 for the three-month periods ended September 30, 2013 and September 30, 2012, respectively, and \$(1,539) and \$861 for the nine-month periods ended September 30, 2013 and September 30, 2012, respectively	139	445	(2,309)	1,292
Less: reclassification adjustment due to gains realized on sales of securities, net of tax effect of \$0 for the three-month periods ended September 30, 2013 and September 30, 2012, and \$(2) and \$0 for the nine-month periods ended September 30, 2013 and September 30, 2012, respectively	—	—	(2)	(1)
Other comprehensive (loss) income	\$139	\$445	\$(2,311)	\$1,291
Comprehensive income	\$1,512	\$1,649	\$1,867	\$4,794

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)

(in thousands, except share data)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total
	Shares	Amounts	Shares	Amounts				
Balance at December 31, 2012	22,847	\$22,847	9,272,668	\$63,410	\$ 977	\$3,917	\$ 1,174	\$92,325
Net income						4,178		4,178
Other comprehensive loss							(2,311)	(2,311)
Redemption of preferred stock	(10,000)	(10,000)						(10,000)
2% stock dividend			185,291	1,047		(1,047)		—
Dividend on preferred stock						(534)		(534)
Cash in lieu of fractional shares			(159)			(4)		(4)
Stock-based compensation				109				109
Tax deficiency related to expired, vested non-qualified stock options				(106)				(106)
Common shares issued related to restricted stock grants, net			20,500					—
Balance at September 30, 2013	12,847	\$12,847	9,478,300	\$64,460	\$ 977	\$6,510	\$ (1,137)	\$83,657

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	(in thousands)	
	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Cash Flows From Operating Activities		
Net Income	\$4,178	\$ 3,503
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	526	518
Accretion and amortization of investment securities premiums and discounts, net	2,656	2,452
Valuation adjustment on mortgage servicing rights	(536)	141
Decrease in deferred loan origination fees and costs, net	(313)	(575)
Provision for loan losses	800	2,051
Stock plan accruals	109	87
Gains on calls of available-for-sale securities	(4)	(1)
Gains on sales of other real estate owned	(1)	(17)
Impairment on other real estate owned	10	16
Gains on sales of loans held-for-sale	(1,121)	(1,410)
Proceeds from sales of loans held-for-sale	61,014	59,496
Originations of loans held-for-sale	(57,125)	(61,183)
Changes in assets and liabilities:		
Decrease in interest receivable and other assets	1,302	1,417
Increase in interest payable and other liabilities	502	495
Net cash provided by operating activities	11,997	6,990
Cash Flows From Investing Activities		
Net increase in investment securities	(9,020)	(23,001)
Net increase in loans	(56,754)	(15,465)
Net increase in stock in Federal Home Loan Bank and other equity securities, at cost	(110)	(532)
Proceeds from sale of other real estate owned	513	2,402
Purchases of premises and equipment, net	(206)	(393)
Net cash used in investing activities	(65,577)	(36,989)
Cash Flows From Financing Activities		
Net increase in deposits	52,703	26,899
Redemption of preferred stock	(10,000)	—
Net decrease in FHLB advances and other borrowings	—	(7,000)
Cash dividends paid in lieu of fractional shares	(4)	(3)
Cash dividends paid on preferred stock	(534)	(857)
Net cash provided by financing activities	42,165	19,039

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Net decrease in Cash and Cash Equivalents	(11,415)	(10,960)
Cash and Cash Equivalents, beginning of period	161,359	140,172
Cash and Cash Equivalents, end of period	\$ 149,944	129,212

Supplemental Disclosures of Cash Flow Information:

Cash paid during the period for:

Interest	\$ 962	\$ 1,477
Income Taxes	\$ 1,260	\$ 1,294

Supplemental disclosures of non-cash investing and financing activities:

Stock dividend distributed	\$ 1,047	\$ 451
Tax deficiency related to expired, vested non-qualified stock options	\$ (106)	\$ —
Transfer of loans held-for-investment to other real estate owned	\$ —	\$ 1,975
Financed sale of other real estate owned	\$ (540)	\$ —
Unrealized holding (losses) gains on available for sale securities, net of taxes	\$ (2,311)	\$ 1,291

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013 and 2012 and December 31, 2012

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, 2012 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 2011, FASB issued ASU 2011-05. This update allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This update eliminates the option to present the components of other comprehensive income as part of the statement of stockholders’ equity. The amendments in this ASU are to be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements. In December 2011, FASB issued ASU 2011-12. This update defers the effective date for amendments to the presentation of reclassifications of items out of accumulated other comprehensive income in ASU 2011-05. In February 2013, FASB issued ASU 2013-02. This update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in ASU 2013-02 are effective prospectively for reporting periods beginning after December 15, 2012. Adoption of the new guidance did not have a significant impact on the Company’s consolidated financial statements.

In December 2011, FASB issued ASU 2011-11. The amendments in this ASU require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments in this ASU are required for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures required by those amendments should be provided retrospectively for all comparative periods presented. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements. In January 2013, FASB issued ASU 2013-01. This update clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. ASU 2011-11 applies only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in the Codification or subject to a master netting arrangement or similar agreement. This update has the same effective date as ASU 2011-11.

In February 2013, FASB issued ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date, which provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. Examples of obligations within the scope of this guidance include debt arrangements, other contractual obligations, and settled litigation and judicial rulings. This guidance is effective for interim and annual periods beginning on January 1, 2014 and must be retroactively applied to prior periods presented. Early adoption is permitted. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In July 2013, FASB issued ASU 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. The amendments in this ASU permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In July 2013, FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The amendments in this ASU provide that an unrecognized tax benefit, or a portion thereof, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption and retrospective application is permitted. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

Reclassifications

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

2. LOANS

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

(\$ in thousands)	September 30, 2013	December 31, 2012
Commercial	\$106,751	\$88,810
Commercial Real Estate	230,284	188,426
Agriculture	49,657	52,747
Residential Mortgage	52,844	51,266
Residential Construction	9,554	7,586
Consumer	55,870	59,393
	504,960	448,228
Allowance for loan losses	(8,792)	(8,554)
Net deferred origination fees and costs	1,088	775
Loans, net	\$497,256	\$440,449

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

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

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment, receivables or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally

are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as adverse weather conditions. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary.

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

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

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

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

As of September 30, 2013, approximately 46% in principal amount of the Company's loans were secured by commercial real estate, which consists primarily of construction and land development loans and loans secured by commercial properties. Approximately 10% in principal amount of the Company's loans were residential mortgage loans. Approximately 2% in principal amount of the Company's loans were residential construction loans. Approximately 10% in principal amount of the Company's loans were for agriculture and 21% in principal amount of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 11% in principal amount of the Company's loans were consumer loans.

Once a loan becomes delinquent and repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not

forthcoming and payment in full is unlikely, the Company will consider the loan to be collateral dependent and will estimate its probable loss, using a recent valuation as appropriate to the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final collection, the Company may periodically revalue the underlying collateral and take additional charge-offs as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when collateral is liquidated and actual loss is known. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

At September 30, 2013 and December 31, 2012, all loans were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank and the Federal Reserve Bank.

Non-accrual and Past Due Loans

The Company's non-accrual loans by loan class, as of September 30, 2013 and December 31, 2012 were as follows:

(\$ in thousands)	September 30, 2013	December 31, 2012
Commercial	\$2,633	\$2,853
Commercial Real Estate	1,943	1,879
Residential Mortgage	2,216	2,095
Residential Construction	99	—
Consumer	231	441
	\$7,122	\$7,268

Non-accrual loans amounted to \$7,122,000 at September 30, 2013 and were comprised of seven residential mortgage loans totaling \$2,216,000, two residential construction loans totaling \$99,000, five commercial real estate loans totaling \$1,943,000, nine commercial loans totaling \$2,633,000 and five consumer loans totaling \$231,000. Non-accrual loans amounted to \$7,268,000 at December 31, 2012 and were comprised of seven residential mortgage loans totaling \$2,095,000, five commercial real estate loans totaling \$1,879,000, eleven commercial loans totaling \$2,853,000 and seven consumer loans totaling \$441,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral.

An age analysis of past due loans, segregated by loan class, as of September 30, 2013 and December 31, 2012 is as follows:

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans
September 30, 2013						
Commercial	\$129	\$145	\$89	\$363	\$106,388	\$106,751
Commercial Real Estate	341	51	531	923	229,361	230,284
Agriculture	—	—	—	—	49,657	49,657
Residential Mortgage	1,690	212	123	2,025	50,819	52,844
Residential Construction	40	9	—	49	9,505	9,554
Consumer	33	46	39	118	55,752	55,870
Total	\$2,233	\$463	\$782	\$3,478	\$501,482	\$504,960
December 31, 2012						
Commercial	\$2,255	\$—	\$170	\$2,425	\$86,385	\$88,810
Commercial Real Estate	1,272	—	566	1,838	186,588	188,426
Agriculture	—	—	—	—	52,747	52,747
Residential Mortgage	570	103	335	1,008	50,258	51,266
Residential Construction	53	—	—	53	7,533	7,586
Consumer	8	747	126	881	58,512	59,393
Total	\$4,158	\$850	\$1,197	\$6,205	\$442,023	\$448,228

The Company had no loans 90 days or more past due and still accruing at September 30, 2013 and December 31, 2012.

Impaired Loans

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

Impaired loans, segregated by loan class, as of September 30, 2013 and December 31, 2012 were as follows:

(\$ in thousands)	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
September 30, 2013					
Commercial	\$ 3,724	\$ 2,469	\$ 941	\$ 3,410	\$ 107
Commercial Real Estate	3,081	1,943	1,135	3,078	20
Agriculture	—	—	—	—	—
Residential Mortgage	6,596	2,216	3,431	5,647	622
Residential Construction	1,129	99	856	955	252
Consumer	921	291	612	903	74
Total	\$ 15,451	\$ 7,018	\$ 6,975	\$ 13,993	\$ 1,075
December 31, 2012					
Commercial	\$ 3,628	\$ 2,769	\$ 519	\$ 3,288	\$ 95
Commercial Real Estate	3,629	1,872	1,170	3,042	26
Agriculture	—	—	—	—	—
Residential Mortgage	5,831	1,860	2,963	4,823	417
Residential Construction	1,148	—	1,097	1,097	433
Consumer	1,416	502	629	1,131	101
Total	\$ 15,652	\$ 7,003	\$ 6,378	\$ 13,381	\$ 1,072

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the three-month periods ended September 30, 2013 and September 30, 2012 was as follows:

(\$ in thousands)	Three Months Ended September 30, 2013		Three Months Ended September 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 3,335	\$ 10	\$ 3,713	\$ 8
Commercial Real Estate	3,341	22	5,019	23
Agriculture	—	—	449	—
Residential Mortgage	5,796	42	4,446	39
Residential Construction	961	10	1,137	12

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Consumer	896	14	949	4
Total	\$14,329	\$ 98	\$15,713	\$ 86

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The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the nine-month periods ended September 30, 2013 and September 30, 2012 was as follows:

(\$ in thousands)	Nine Months Ended September 30, 2013		Nine Months Ended September 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	\$3,342	\$ 29	\$3,689	\$ 28
Commercial Real Estate	3,180	65	4,745	68
Agriculture	—	—	1,517	—
Residential Mortgage	5,267	103	4,374	98
Residential Construction	1,027	33	1,178	38
Consumer	974	30	874	21
Total	\$13,790	\$ 260	\$16,377	\$ 253

None of the interest on impaired loans was recognized using a cash basis of accounting for the three-month and nine-month periods ended September 30, 2013 and September 30, 2012.

Troubled Debt Restructurings

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

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

The Company had \$9,903,000 and \$8,863,000 in TDR loans as of September 30, 2013 and December 31, 2012, respectively. Specific reserves for TDR loans totaled \$978,000 and \$939,000 as of September 30, 2013 and December 31, 2012, respectively. TDR loans performing in compliance with modified terms totaled \$6,798,000 and \$6,040,000 as of September 30, 2013 and December 31, 2012, respectively. There are no commitments to advance more funds on existing TDR loans as of September 30, 2013.

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Loans modified as troubled debt restructurings during the three-month periods ended September 30, 2013 and September 30, 2012 were as follows:

(\$ in thousands)	Three Months Ended September 30, 2013		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Commercial	1	\$ 149	\$ 149
Consumer	3	233	233
Total	4	\$ 382	\$ 382

(\$ in thousands)	Three Months Ended September 30, 2012		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Consumer	2	\$ 142	\$ 142
Total	2	\$ 142	\$ 142

Loans modified as troubled debt restructurings during the nine-month periods ended September 30, 2013 and September 30, 2012 were as follows:

(\$ in thousands)	Nine Months Ended September 30, 2013		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Commercial	2	\$ 393	\$ 393
Residential Mortgage	1	568	377
Consumer	3	233	233
Total	6	\$ 1,194	\$ 1,003

(\$ in thousands)	Nine months Ended September 30, 2012		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Commercial	4	\$ 361	\$ 361
Commercial Real Estate	1	1,188	1,188
Residential Mortgage	1	806	806
Consumer	6	572	572
Total	12	\$ 2,927	\$ 2,927

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. There were no loans modified as a troubled debt restructuring within the previous 12 months for which there was a payment default during the three-month periods ended September 30, 2013 and September 30,

2012. There were no loans modified as a troubled debt restructuring within the previous 12 months for which there was a payment default during the nine-month period ended September 30, 2013. There was one commercial loan with a recorded investment of \$136,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the nine-month period ended September 30, 2012.

Credit Quality Indicators

All loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and 8 equates to a Loss. For the definitions of each risk rating, see Note 4 to our condensed consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012.

The following table presents the risk ratings by loan class as of September 30, 2013 and December 31, 2012.

(\$ in thousands)	Pass	Special Mention	Substandard	Doubtful	Loss	Total
September 30, 2013						
Commercial	\$97,650	\$3,898	\$5,203	\$—	\$—	\$106,751
Commercial Real Estate	213,267	6,687	10,330	—	—	230,284
Agriculture	46,993	—	2,664	—	—	49,657
Residential Mortgage	48,650	796	3,398	—	—	52,844
Residential Construction	8,020	—	1,534	—	—	9,554
Consumer	49,360	4,214	2,296	—	—	55,870
Total	\$463,940	\$15,595	\$25,425	\$—	\$—	\$504,960
December 31, 2012						
Commercial	\$78,078	\$4,393	\$6,339	\$—	\$—	\$88,810
Commercial Real Estate	170,676	9,049	8,701	—	—	188,426
Agriculture	49,613	172	2,962	—	—	52,747
Residential Mortgage	45,962	604	4,700	—	—	51,266
Residential Construction	5,512	1,212	862	—	—	7,586
Consumer	51,444	4,822	3,054	73	—	59,393
Total	\$401,285	\$20,252	\$26,618	\$73	\$—	\$448,228

Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2013.

Three-month period ended September 30, 2013

(\$ in thousands)	Commercial			Residential		Consumer	Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Residential Construction			
Balance as of June, 30, 2013	\$ 2,869	\$ 2,037	\$ 748	\$ 1,054	\$ 503	\$ 1,041	\$ 474	\$8,726
Provision for loan losses	191	309	(137)	(127)	(70)	126	(292)	—
Charge-offs	(1)	—	—	—	—	(115)	—	(116)
Recoveries	25	—	—	145	1	11	—	182
Net charge-offs	24	—	—	145	1	(104)	—	66
Balance as of September 30, 2013	\$ 3,084	\$ 2,346	\$ 611	\$ 1,072	\$ 434	\$ 1,063	\$ 182	\$8,792

Nine-month period ended September 30, 2013

(\$ in thousands)	Commercial			Residential		Consumer	Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Residential Construction			
Balance as of December 31, 2012	\$ 2,899	\$ 1,723	\$ 915	\$ 1,148	\$ 724	\$ 1,110	\$ 35	\$8,554
Provision for loan losses	149	575	(306)	100	(207)	342	147	800
Charge-offs	(113)	(3)	(1)	(333)	(127)	(491)	—	(1,068)
Recoveries	149	51	3	157	44	102	—	506
Net charge-offs	36	48	2	(176)	(83)	(389)	—	(562)
Balance as of September 30, 2013	\$ 3,084	\$ 2,346	\$ 611	\$ 1,072	\$ 434	\$ 1,063	\$ 182	\$8,792

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2013.

(\$ in thousands)	Commercial			Residential		Consumer	Unallocated	Total
	Commercial	Real Estate	Agriculture	Mortgage	Residential Construction			
Period-end amount allocated to:	\$	\$	\$	\$	\$	\$	\$	\$
Loans individually evaluated for	107	20	—	622	252	74	—	1,075

impairment

Loans collectively
evaluated for

impairment	2,977	2,326	611	450	182	989	182	7,717
Ending Balance	\$ 3,084	\$ 2,346	\$ 611	\$ 1,072	\$ 434	\$ 1,063	\$ 182	\$8,792

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The following table details activity in the allowance for loan losses by loan class for the three-month and nine-month periods ended September 30, 2012.

Three-month period ended September 30, 2012

(\$ in thousands)	Commercial							Unallocated	Total
	Commercial	Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer			
Balance as of June 30, 2012	\$ 2,782	\$ 2,062	\$ 1,126	\$ 1,616	\$ 934	\$ 1,101	\$ 163	\$9,784	
Provision for loan losses	341	203	(244)	223	(102)	100	304	825	
Charge-offs	(25)	(4)	—	(833)	—	(34)	—	(896)	
Recoveries	41	—	—	—	36	27	—	104	
Net charge-offs	16	(4)	—	(833)	36	(7)	—	(792)	
Balance as of September 30, 2012	3,139	2,261	882	1,006	868	1,194	467	9,817	

Nine-month period ended September 30, 2012

(\$ in thousands)	Commercial							Unallocated	Total
	Commercial	Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer			
Balance as of December 31, 2011	\$ 3,598	\$ 1,747	\$ 1,934	\$ 1,135	\$ 1,198	\$ 796	\$ —	\$10,408	
Provision for loan losses	367	860	(940)	735	(429)	991	467	2,051	
Charge-offs	(1,104)	(346)	(115)	(864)	(161)	(668)	—	(3,258)	
Recoveries	278	—	3	—	260	75	—	616	
Net charge-offs	(826)	(346)	(112)	(864)	99	(593)	—	(2,642)	
Balance as of September 30, 2012	3,139	2,261	882	1,006	868	1,194	467	9,817	

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of September 30, 2012.

(\$ in thousands)	Commercial							Unallocated	Total
	Commercial	Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer			
Period-end amount allocated to:									
Loans individually evaluated for impairment	152	19	—	497	563	86	—	1,317	

Loans collectively evaluated for impairment	2,987	2,242	882	509	305	1,108	467	8,500
Ending Balance	\$ 3,139	\$ 2,261	\$ 882	\$ 1,006	\$ 868	\$ 1,194	\$ 467	\$9,817

The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the period ended December 31, 2012.

(\$ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of								
December 31, 2011	\$ 3,598	\$ 1,747	\$ 1,934	\$ 1,135	\$ 1,198	\$ 796	\$ —	\$ 10,408
Provision for loan losses	2,493	351	(907)	877	(648)	1,075	35	3,276
Charge-offs	(3,498)	(375)	(116)	(864)	(167)	(875)	—	(5,895)
Recoveries	306	—	4	—	341	114	—	765
Net charge-offs	(3,192)	(375)	(112)	(864)	174	(761)	—	(5,130)
Balance as of								
December 31, 2012	2,899	1,723	915	1,148	724	1,110	35	8,554
Period-end amount allocated to:								
Loans individually evaluated for impairment	95	26	—	417	433	101	—	1,072
Loans collectively evaluated for impairment	2,804	1,697	915	731	291	1,009	35	7,482
Balance as of								
December 31, 2012	\$ 2,899	\$ 1,723	\$ 915	\$ 1,148	\$ 724	\$ 1,110	\$ 35	\$ 8,554

The Company's investment in loans as of September 30, 2013, September 30, 2012, and December 31, 2012 related to each balance in the allowance for loan losses by loan class and disaggregated on the basis of the Company's impairment methodology was as follows:

(\$ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Total
September 30, 2013							
Loans individually evaluated for impairment	\$ 3,410	\$ 3,078	\$ —	\$ 5,647	\$ 955	\$ 903	\$ 13,993
Loans collectively evaluated for impairment	103,341	227,206	49,657	47,197	8,599	54,967	490,967
Ending Balance	\$ 106,751	\$ 230,284	\$ 49,657	\$ 52,844	\$ 9,554	\$ 55,870	\$ 504,960
September 30, 2012							
	\$ 3,604	\$ 4,800	\$ —	\$ 4,905	\$ 1,147	\$ 864	\$ 15,320

Loans
individually
evaluated for
impairment

Loans collectively evaluated for impairment	90,284	187,950	49,103	44,747	6,435	60,008	438,527
Ending Balance	\$ 93,888	\$ 192,750	\$ 49,103	\$ 49,652	\$ 7,582	\$ 60,872	\$ 453,847

December 31, 2012

Loans
individually
evaluated for
impairment

Loans collectively evaluated for impairment	85,522	185,384	52,747	46,443	6,489	58,262	434,847
Ending Balance	\$ 88,810	\$ 188,426	\$ 52,747	\$ 51,266	\$ 7,586	\$ 59,393	\$ 448,228

3. MORTGAGE OPERATIONS

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

The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold. The Company sold substantially its entire portfolio of conforming long-term residential mortgage loans originated during the nine months ended September 30, 2013 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. Changes in the carrying amount of mortgage servicing rights are reported in earnings under Other income.

Key assumptions used in measuring the fair value of MSR as of September 30, 2013 were as follows:

	September 30, 2013
Constant prepayment rate	11.27 %
Discount rate	10.06 %
Weighted average life (years)	6.37

At September 30, 2013, the Company had \$1,791,000 of mortgage loans held-for-sale. At September 30, 2013 and December 31, 2012, the Company serviced real estate mortgage loans for others of \$247,242,000 and \$235,561,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2013 and December 31, 2012. Mortgage servicing rights are included in Interest Receivable and Other Assets in the consolidated balance sheets.

	(in thousands)			
	December 31, 2012	Additions	Reductions	September 30, 2013
Mortgage servicing rights	\$1,760	\$543	\$(339)	\$1,964
Valuation allowance	(536)	—	536	—
Mortgage servicing rights, net of valuation allowance	\$1,224	\$543	\$197	\$1,964

The Company received contractually specified servicing fees of \$155,000 and \$142,000 for the three month periods ended September 30, 2013 and September 30, 2012, respectively. The Company received contractually specified servicing fees of \$462,000 and \$414,000 for the nine month periods ended September 30, 2013 and September 30, 2012, respectively. Contractually specified servicing fees are included in Other Income on the consolidated statements of income.

4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 24, 2013, the Board of Directors of the Company declared a 2% stock dividend payable as of March 29, 2013. All income per share amounts have been adjusted to give retroactive effect to stock dividends.

Earnings Per Share (EPS)

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

The following table presents a reconciliation of basic and diluted EPS for the three-month and nine-month periods ended September 30, 2013 and 2012.

(\$ in thousands)	Three months ended		Nine months ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Basic earnings per share:				
Net income	\$1,373	\$1,204	\$4,178	\$3,503
Preferred stock dividend	\$(162)	\$(286)	\$(534)	\$(857)
Net income available to common shareholders	\$1,211	\$918	\$3,644	\$2,646
Weighted average common shares outstanding	9,418,268	9,385,824	9,413,212	9,383,038
Basic EPS	\$0.13	\$0.10	\$0.39	\$0.28
Diluted earnings per share:				
Net income	\$1,373	\$1,204	\$4,178	\$3,503
Preferred stock dividend	\$(162)	\$(286)	\$(534)	\$(857)
Net income available to common shareholders	\$1,211	\$918	\$3,644	\$2,646
Weighted average common shares outstanding	9,418,268	9,385,824	9,413,212	9,383,038
Effect of dilutive shares	37,730	25,827	33,881	25,754
Adjusted weighted average common shares outstanding	9,455,998	9,411,651	9,447,093	9,408,792
Diluted EPS	\$0.13	\$0.10	\$0.39	\$0.28

Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 301,793 shares and 356,805 shares for the three-month periods ended September 30, 2013 and 2012, respectively. Stock options which were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 313,543 shares and 354,478 shares for the nine-month periods ended September 30, 2013 and 2012, respectively. There were no non-vested shares of restricted stock not included in the computation of diluted earnings per share because they would have an anti-dilutive effect for the three-month periods ended September 30, 2013 and 2012. Non-vested shares of restricted stock that were not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect

amounted to 2,769 shares and zero shares for the nine-month periods ended September 30, 2013 and 2012, respectively.

5. STOCK PLANS

On January 24, 2013, the Board of Directors of the Company declared a 2% stock dividend payable as of March 29, 2013. All stock options and restricted stock outstanding have been adjusted to give retroactive effect to stock dividends.

The following table presents the activity related to stock options for the three months ended September 30, 2013.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
Options outstanding at Beginning of Period	357,493	\$ 11.87		
Granted	—	—		
Expired	—	—		
Cancelled / Forfeited	—	—		
Exercised	—	—		
Options outstanding at End of Period	357,493	\$ 11.87	\$ 156,377	2.98
Exercisable (vested) at End of Period	311,503	\$ 12.84	\$ 81,822	2.16

The following table presents the activity related to stock options for the nine months ended September 30, 2013.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
Options outstanding at Beginning of Period	383,045	\$ 11.71		
Granted	22,950	\$ 5.88		
Expired	(48,502)	\$ 7.74		
Cancelled / Forfeited	—	—		
Exercised	—	—		
Options outstanding at End of Period	357,493	\$ 11.87	\$ 156,377	2.98

Exercisable (vested) at End of Period	311,503	\$12.84	\$81,822	2.16
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The weighted average grant date fair value per share of options granted during the nine-month period ended September 30, 2013 was \$2.75 per share.

As of September 30, 2013, there was \$90,000 of total unrecognized compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted average period of approximately 2.79 years.

There was \$29,000 of recognized compensation cost related to stock options granted for the nine months ended September 30, 2013.

A summary of the weighted average assumptions used in valuing stock options during the three months and nine months ended September 30, 2013 is presented below.

	Three Months Ended September 30, 2013*	Nine months Ended September 30, 2013	
Risk Free Interest Rate	—	0.86	%
Expected Dividend Yield	—	0.00	%
Expected Life in Years	—	5	
Expected Price Volatility	—	54.36	%

* There were no stock options granted during the three-month period ended September 30, 2013.

The following table presents the activity related to non-vested restricted stock for the three months ended September 30, 2013.

	Number of Shares	Weighted Average Grant-Date Fair Value	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
Non-vested restricted stock outstanding at Beginning of Period	58,282	\$5.00		
Granted	1,500	\$5.96		
Cancelled / Forfeited	—	—		
Exercised/Released/Vested	—	—		
Non-vested restricted stock outstanding at End of Period	59,782	\$5.03	\$411,898	8.15

The following table presents the activity related to non-vested restricted stock for the nine months ended September 30, 2013.

	Number of Shares	Weighted Average Grant-Date Fair Value	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (in years)
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Non-vested restricted stock outstanding at Beginning of Period	47,707	\$4.53		
Granted	20,880	\$5.89		
Cancelled / Forfeited	—	—		
Exercised/Released/Vested	(8,805)	\$4.37	
Non-vested restricted stock outstanding at End of Period	59,782	\$5.03	\$411,898	8.15

The weighted average fair value of restricted stock granted during the three and nine month periods ended September 30, 2013 was \$5.96 and \$5.89 per share, respectively.

As of September 30, 2013, there was \$172,000 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 2.76 years.

There was \$54,000 of recognized compensation cost related to restricted stock awards for the nine months ended September 30, 2013.

The Company has an Employee Stock Purchase Plan (“ESPP”). Under the ESPP, the Company is authorized to issue to eligible employees shares of common stock. There are 300,958 (adjusted for the 2013 stock dividend) shares authorized under the ESPP. The ESPP will terminate March 15, 2016. 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, 2012 to November 23, 2013. An eligible employee is one who has been continually employed for at least 90 days prior to commencement of a participation period. Under the terms of the ESPP, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company’s common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair value on the last trading day before the date of participation or the fair value on the last trading day during the participation period.

As of September 30, 2013, there was \$8,000 of unrecognized compensation cost related to ESPP issuances. This cost is expected to be recognized over a weighted average period of approximately 0.25 years.

There was \$26,000 of recognized compensation cost related to ESPP issuances for the nine-month period ended September 30, 2013.

The weighted average fair value at issuance date during the nine-month period ended September 30, 2013 was \$1.18.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three months and nine months ended September 30, 2013 is presented below.

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
Risk Free Interest Rate	0.19	%	0.19	%
Expected Dividend Yield	0.00	%	0.00	%
Expected Life in Years	1.00		1.00	
Expected Price Volatility	20.00	%	20.00	%

6. FAIR VALUE MEASUREMENT

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

Fair Value Hierarchy

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

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

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

Investment Securities Available-for-Sale

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

Loans Held-for-Sale

Loans held-for-sale are carried at the lower of cost or fair value. The fair value of loans held-for-sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies loans subjected to non-recurring fair value adjustments as Level 2. At September 30, 2013 there were no loans held-for-sale that required a write-down.

Impaired Loans

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

At September 30, 2013, certain impaired loans were considered collateral dependent and were evaluated based on the fair value of the underlying collateral securing the loan. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When a loan is evaluated based on the fair value of the underlying collateral securing the loan, the Company records the impaired loan as non-recurring Level 3.

Other Real Estate Owned

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

Loan Servicing Rights

Loan servicing rights are subject to impairment testing. The Company utilizes a third party service provider to calculate the fair value of the Company’s loan servicing rights. Loan servicing rights are measured at fair value as of the date of sale. The Company uses quoted market prices when available. Subsequent fair value measurements are determined using a discounted cash flow model. In order to determine the fair value of the loan servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. At September 30, 2013, the discount rate and constant prepayment rate used in measuring the fair value of the Company’s loan servicing rights was 10.06% and 11.27%, respectively.

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

Assets Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of September 30, 2013.

September 30, 2013	(in thousands)			
	Total	Level 1	Level 2	Level 3
U.S. Treasury securities	\$1,001	\$1,001	\$—	\$—
Securities of U.S. government agencies and corporations	58,900	—	58,900	—
Obligations of states and political subdivisions	27,317	—	27,317	—
Collateralized mortgage obligations	5,861	—	5,861	—
Mortgage-backed securities	93,928	—	93,928	—
Total investments at fair value	\$187,007	\$1,001	\$186,006	\$—

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2012.

December 31, 2012	(in thousands)			
	Total	Level 1	Level 2	Level 3
U.S. Treasury securities	\$1,005	\$1,005	\$—	\$—
Securities of U.S. government agencies and corporations	28,305	—	28,305	—
Obligations of states and political subdivisions	28,786	—	28,786	—
Collateralized mortgage obligations	8,278	—	8,278	—
Mortgage-backed securities	118,117	—	118,117	—
Total investments at fair value	\$184,491	\$1,005	\$183,486	\$—

Assets Recorded at Fair Value on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of September 30, 2013.

September 30, 2013	(in thousands)			
	Total	Level 1	Level 2	Level 3
Impaired loans	\$989	\$—	\$—	\$989
Loan servicing rights	1,964	—	—	1,964
Total assets at fair value	\$2,953	\$—	\$—	\$2,953

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, 2012.

December 31, 2012	(in thousands)			
	Total	Level 1	Level 2	Level 3
Impaired loans	\$2,513	\$—	\$—	\$2,513
Other real estate owned	1,062	—	—	1,062
Loan servicing rights	1,224	—	—	1,224
Total assets at fair value	\$4,799	\$—	\$—	\$4,799

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2013 and December 31, 2012.

7. PREFERRED STOCK

On September 15, 2011, the Company issued to the U.S. Treasury under the United States Department of Treasury Small Business Lending Fund (SBLF) 22,847 shares of the Company's Non-Cumulative Perpetual Preferred Stock, Series A (SBLF Shares), having a liquidation preference per share equal to \$1,000, for an aggregate purchase price of \$22,847,000.

On September 15, 2011, the Company redeemed from the U.S. Treasury, using the partial proceeds from the issuance of the SBLF Shares, all 17,390 outstanding shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, liquidation amount \$1,000 per share, for a redemption price of \$17,390,000, plus accrued but unpaid dividends at the date of redemption.

On February 8, 2013, the Company redeemed \$10,000,000 of the \$22,847,000 in preferred stock it issued to the U.S. Treasury under the SBLF program.

8. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

Cash and Cash Equivalents

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

Other Equity Securities

The carrying amounts reported in the consolidated balance sheet are reflected at cost, which approximates fair value. The Company believes the measurement of the fair value of other equity securities is derived from Level 2 inputs.

Loans Receivable

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., commercial real estate and rental property mortgage loans, commercial and industrial loans, and agricultural loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. Given that there are loans with specific terms that are not readily available, the Company believes the fair value of loans receivable is derived from Level 3 inputs.

Loans Held-for-Sale

For loans held for sale, carrying value approximates fair value. See FN(6), Fair Value Measurement.

Interest receivable and payable

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

Deposit Liabilities

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

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. The Company believes the measurement of the fair value of FHLB advances and other borrowings is derived from Level 2 inputs.

Limitations

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

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

The estimated fair values of the Company's financial instruments for the periods ended September 30, 2013 and December 31, 2012 are approximately as follows:

		September 30, 2013		December 31, 2012	
	Level	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:					
Cash and cash equivalents	1	\$149,944	\$149,944	\$161,359	\$161,359
Other equity securities	2	3,717	3,717	3,607	3,607
Loans receivable:					
Net loans	3	497,256	494,200	440,449	437,818
Loans held-for-sale	2	1,791	1,803	4,559	4,704
Interest receivable	2	2,762	2,762	2,542	2,542
Financial liabilities:					
Deposits	3	783,514	771,675	730,811	720,690
Interest payable	2	84	84	94	94

9. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2013 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
U.S. Treasury securities	\$999	\$2	\$—	\$1,001
Securities of U.S. government agencies and corporations	60,025	26	(1,151)	58,900
Obligations of states and political subdivisions	27,182	568	(433)	27,317
Collateralized mortgage obligations	5,845	20	(4)	5,861
Mortgage-backed securities	93,751	601	(424)	93,928
Total debt securities	\$187,802	\$1,217	\$(2,012)	\$187,007

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2012 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
U.S. Treasury securities	\$997	\$8	\$—	\$1,005
Securities of U.S. government agencies and corporations	28,200	105	—	28,305
Obligations of states and political subdivisions	27,226	1,563	(3)	28,786
Collateralized mortgage obligations	8,156	123	(1)	8,278
Mortgage-backed securities	116,855	1,524	(262)	118,117
Total debt securities	\$181,434	\$3,323	\$(266)	\$184,491

There were no proceeds from sales of available-for-sale securities for the nine-month and three-month periods ended September 30, 2013 and September 30, 2012. Gross realized gains from calls of available-for-sale securities were \$4 and \$0 for the nine-month and three-month periods ended September 30, 2013, respectively. Gross realized gains from calls of available-for-sale securities were \$1 and \$0 for the nine-month and three-month periods ended September 30, 2012, respectively. There were no gross realized losses from sales of available-for-sale securities for the nine-month and three-month periods ended September 30, 2013 and September 30, 2012.

The amortized cost and estimated market value of debt and other securities at September 30, 2013, by contractual and expected maturity, are shown in the following table.

(in thousands)	Amortized cost	Estimated fair value
Due in one year or less	\$14,628	\$14,666
Due after one year through five years	126,760	126,636
Due after five years through ten years	39,930	39,212
Due after ten years	6,484	6,493

\$187,802 \$187,007

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 with expected maturities totaling \$91,963,000. The maturities on these securities were based on the average lives of the securities.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of September 30, 2013, follows:

(in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized losses	Fair Value	Unrealized losses	Fair Value	Unrealized losses
Securities of U.S. government agencies and corporations	\$47,358	\$(1,151)	\$—	\$—	\$47,358	\$(1,151)
Obligations of states and political subdivisions	10,243	(433)	—	—	10,243	(433)
Collateralized mortgage obligations	1,880	(4)	—	—	1,880	(4)
Mortgaged-backed securities	38,556	(402)	801	(22)	39,357	(424)
Total	\$98,037	\$(1,990)	\$801	\$(22)	\$98,838	\$(2,012)

No decline in value was considered “other-than-temporary” during 2013. Seventy-four securities, all considered investment grade, which had a fair value of \$98,037,000 and a total unrealized loss of \$1,990,000 have been in an unrealized loss position for less than twelve months as of September 30, 2013. One security, considered investment grade, which had a fair value of \$801,000 and a total unrealized loss of \$22,000 had been in an unrealized loss position for more than twelve months as of September 30, 2013. The declines in fair value were primarily attributable to changes in interest rates. As the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities prior to their anticipated recovery, these investments are not considered other-than-temporarily impaired.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2012, follows:

(in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized losses	Fair Value	Unrealized losses	Fair Value	Unrealized losses
Obligations of states and political subdivisions	\$1,262	\$(3)	\$—	\$—	\$1,262	\$(3)
Collateralized mortgage obligations	1,198	(1)	—	—	1,198	(1)
Mortgage-backed securities	29,779	(262)	—	—	29,779	(262)

Total	\$32,239	\$(266)	\$—	\$—	\$32,239	\$(266)
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Investment securities carried at \$29,482,000 and \$32,227,000 at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table details activity in accumulated other comprehensive (loss) income for the three-month period ended September 30, 2013.

(\$ in thousands)	Unrealized Gains on Securities	Directors' and officers' retirement plans	Accumulated Other Comprehensive (Loss) Income
Balance as of June 30, 2013	\$(616)	\$(660)	\$ (1,276)
Current period other comprehensive income	139	—	139
Balance as of September 30, 2013	\$(477)	\$(660)	\$ (1,137)

The following table details activity in accumulated other comprehensive income for the nine-month period ended September 30, 2013.

(\$ in thousands)	Unrealized Gains on Securities	Directors' and officers' retirement plans	Accumulated Other Comprehensive (Loss) Income
Balance as of December 31, 2012	\$1,834	\$(660)	\$ 1,174
Current period other comprehensive loss	(2,311)	—	(2,311)
Balance as of September 30, 2013	\$(477)	\$(660)	\$ (1,137)

During the nine-month period ended September 30, 2013, the Company incurred a net increase in unrealized loss of approximately \$3,852,000, in the Company's investment portfolio, resulting in comprehensive loss, net of tax of \$2,311,000, recognized in the Consolidated Statements of Comprehensive Income. The net increase in unrealized loss is due to increases in intermediate to long-term market rates of U.S. Treasury securities.

The following table details activity in accumulated other comprehensive income for the three-month period ended September 30, 2012.

(\$ in thousands)	Unrealized Gains on Securities	Directors' and officers' retirement plans	Accumulated Other Comprehensive Income
Balance as of June 30, 2012	\$1,604	\$(495)	\$ 1,109
Current period other comprehensive income	445	—	445
Balance as of September 30, 2012	\$2,049	\$(495)	\$ 1,554

The following table details activity in accumulated other comprehensive income for the nine-month period ended September 30, 2012.

(\$ in thousands)

	Unrealized Gains on Securities	Directors' and officers' retirement plans	Accumulated Other Comprehensive Income
Balance as of December 31, 2011	\$758	\$(495)	\$ 263
Current period other comprehensive income	1,291	—	1,291
Balance as of September 30, 2012	\$2,049	\$(495)	\$ 1,554

11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

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

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

(in thousands)	September 30, 2013	December 31, 2012
Undisbursed loan commitments	\$172,755	\$159,329
Standby letters of credit	2,387	2,376
Commitments to sell loans	1,977	7,480
	\$177,119	\$169,185

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank issues both financial and performance standby letters of credit. The financial standby letters of credit are primarily to guarantee payment to third parties. At September 30, 2013, there were no financial standby letters of credit outstanding. The performance standby letters of credit are typically issued to municipalities as specific performance bonds. At September 30, 2013, there was \$2,387,000 issued in performance standby letters of credit and the Bank carried no liability. The Bank has experienced no draws on these letters of credit; however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of \$793,000 at September 30, 2013, which is recorded in "interest payable and other liabilities" on the Consolidated Balance Sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of September 30, 2013, the Company had no off-balance sheet derivatives requiring additional disclosure.

Mortgage loans sold to investors may be sold with servicing rights retained, for which the Company makes only standard legal representations and warranties as to meeting certain underwriting and collateral documentation standards. In the past two years, the number of loans the Company has had to repurchase due to deficiencies in underwriting or loan documentation is not significant. Management believes that any liabilities that may result from such recourse provisions are not significant.

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 2012 Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q for factors to be considered when reading any forward-looking statements in this filing.

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

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

- Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position
 - Our assessment of significant factors and developments that have affected or may affect our results
- Pending and recent legal and regulatory actions, and future legislative and regulatory developments, including the effects of the Dodd-Frank Wall Street Reform and Protection Act (the “Dodd-Frank Act”) and other legislation and governmental measures introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy
 - Regulatory controls and processes and their impact on our business
 - The costs and effects of legal or regulatory actions
 - We do not expect draws on performance letters of credit
- Our regulatory capital requirements, including the recently adopted capital rules by the U.S. federal banking agencies
 - We do not anticipate paying a cash dividend in the foreseeable future

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

- The seasonal nature of our business
- The impact of changes in interest rates and our strategy to manage our interest rate risk profile
- Loan portfolio composition and risk grade trends, expected charge offs, delinquency rates and our underwriting standards
 - Our deposit base including renewal of time deposits
- The impact on our net interest income and net interest margin from the current low-interest rate environment
 - The Company does not anticipate any significant increase or decrease in unrecognized tax benefits
 - Our pension and retirement plan costs
 - Our liquidity position
- Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or changes in accounting principles
 - Expected rates of return, 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 2012 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, 2012.

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 present challenges to our ability to generate those revenues.

Significant results and developments during the third quarter and year-to-date 2013 include:

- Net income of \$4.2 million for the nine months ended September 30, 2013, up 20.0% from \$3.5 million for the same fiscal period last year.
- Net income available to common shareholders of \$3.6 million for the nine months ended September 30, 2013, up 38.5% from \$2.6 million for the same fiscal period last year.
- Diluted income per share for the nine-month period ended September 30, 2013 was \$0.39, up 39.3% from diluted income per share of \$0.28 in the same period last year.
- Net interest income increased in the nine months ended September 30, 2013 by \$688,000, or 3.5%, to \$20.4 million from \$19.7 million in the same period last year. The increase in net interest income was primarily attributable to an increase in interest income on loans and a decrease in interest costs. The increase in interest income on loans is primarily due to an increase in average loans, partially offset by a decrease in interest yield. The decrease in interest costs is primarily attributable to a decrease in the Company's average cost of funds, partially offset by an increase in average interest-bearing deposits. Net interest margin decreased from 3.57% for the nine-month period ending September 30, 2012 to 3.42% for the same period ending September 30, 2013.
- Provision for loan losses of \$0.8 million for the nine-month period ended September 30, 2013 compared to a provision for loan losses of \$2.1 million for the same period in 2012.
- Total assets at September 30, 2013 were \$876.0 million, an increase of \$44.5 million, or 5.4%, compared to total assets at December 31, 2012.
- Total net loans at September 30, 2013 (including loans held-for-sale) increased \$54.0 million, or 12.1%, to \$499.0 million compared to December 31, 2012.
- Total investment securities at September 30, 2013 increased \$2.5 million, or 1.4%, to \$187.0 million compared to December 31, 2012.
- Total deposits of \$783.5 million at September 30, 2013, represented an increase of \$52.7 million, or 7.2%, compared to December 31, 2012.

- During the nine-month period ended September 30, 2013, the Company incurred a net increase in unrealized loss of approximately \$3,852,000, in the Company's investment portfolio, resulting in comprehensive loss, net of tax of \$2,311,000, recognized in the Consolidated Statements of Comprehensive Income. The net increase in unrealized loss is due to increases in intermediate to long-term market rates of U.S. Treasury securities.
- Net income of \$1.4 million for the three months ended September 30, 2013, up 16.7% from \$1.2 million for the same fiscal period last year.
- Net income available to common shareholders of \$1.2 million for the three months ended September 30, 2013, up 33.3% from \$0.9 million for the same period last year.

- Diluted income per share for the three-month period ended September 30, 2013 was \$0.13, up 30.0% from a diluted income per share of \$0.10 for the same period last year.

SUMMARY

The Company recorded net income of \$4,178,000 for the nine-month period ended September 30, 2013, representing an increase of \$675,000 from net income of \$3,503,000 for the same period in 2012. The Company recorded net income of \$1,373,000 for the three-month period ended September 30, 2013, representing an increase of \$169,000 from net income of \$1,204,000 for the same period in 2012.

The following tables present a summary of the results for the three-month and nine-month periods ended September 30, 2013 and 2012, and a summary of financial condition at September 30, 2013 and December 31, 2012.

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
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(in thousands except for per share amounts)

For the Period:

Net Income	\$1,373	\$1,204	\$4,178	\$3,503
Basic Earnings Per Common Share	\$0.13	\$0.10	\$0.39	\$0.28
Diluted Earnings Per Common Share	\$0.13	\$0.10	\$0.39	\$0.28

	September 30, 2013	December 31, 2012
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(in thousands except for ratios)

At Period End:

Total Assets	\$876,020	\$831,483
Total Loans, Net (including loans held-for-sale)	\$499,047	\$445,008
Total Investment Securities	\$187,007	\$184,491
Total Deposits	\$783,514	\$730,811
Loan-To-Deposit Ratio	63.7 %	60.9 %

FIRST NORTHERN COMMUNITY BANCORP

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

	Three months ended September 30, 2013			Three months ended September 30, 2012				
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate		
Assets								
Interest-earning assets:								
Loans (1)	\$483,868	\$6,466	5.30 %	\$446,874	\$6,211	5.51 %		
Interest bearing due from banks	134,266	103	0.30 %	107,311	77	0.28 %		
Investment securities, taxable	180,002	621	1.37 %	172,516	756	1.74 %		
Investment securities, non-taxable (2)	9,770	99	4.02 %	10,470	103	3.90 %		
Other interest earning assets	3,717	46	4.91 %	3,607	5	0.55 %		
Total average interest-earning assets	811,623	7,335	3.59 %	740,778	7,152	3.83 %		
Non-interest-earning assets:								
Cash and due from banks	17,033			16,527				
Premises and equipment, net	7,593			8,005				
Other real estate owned	—			565				
Interest receivable and other assets	28,880			30,279				
Total average assets	865,129			796,154				
Liabilities and Stockholders' Equity:								
Interest-bearing liabilities:								
Interest-bearing transaction								
deposits	199,490	67	0.13 %	171,184	61	0.14 %		
Savings and MMDA's	227,290	144	0.25 %	214,161	160	0.30 %		
Time, under \$100,000	33,866	32	0.37 %	36,916	48	0.52 %		
Time, \$100,000 and over	54,947	63	0.45 %	59,364	106	0.71 %		
Total average interest-bearing liabilities	515,593	306	0.24 %	481,625	375	0.31 %		
Non-interest-bearing liabilities:								
Non-interest-bearing demand deposits	257,810			216,059				
Interest payable and other liabilities	8,488			7,433				
Total liabilities	781,891			705,117				
Total average stockholders' equity	83,238			91,037				
Total average liabilities and stockholders' equity	\$865,129			\$796,154				
Net interest income and net interest margin (3)		\$7,029	3.44 %		\$6,777	3.63 %		

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 \$360 and \$257 for the three months ended September 30, 2013 and 2012, 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)

	Nine months ended September 30, 2013			Nine months ended September 30, 2012				
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate		
Assets								
Interest-earning assets:								
Loans (1)	\$459,689	\$18,671	5.43	%	\$433,928	\$18,245	5.60	%
Interest bearing due from banks	140,984	315	0.30	%	116,261	251	0.29	%
Investment securities, taxable	183,083	1,961	1.43	%	171,639	2,334	1.81	%
Investment securities, non-taxable (2)	9,972	298	4.00	%	10,490	310	3.94	%
Other interest earning assets	3,671	106	3.86	%	3,374	17	0.67	%
Total average interest-earning assets	797,399	21,351	3.58	%	735,692	21,157	3.83	%
Non-interest-earning assets:								
Cash and due from banks	16,458				15,809			
Premises and equipment, net	7,707				8,068			
Other real estate owned	535				960			
Interest receivable and other assets	28,848				31,244			
Total average assets	850,947				791,773			
Liabilities and Stockholders' Equity:								
Interest-bearing liabilities:								
Interest-bearing transaction								
deposits	194,082	195	0.13	%	165,745	243	0.20	%
Savings and MMDA's	224,880	447	0.27	%	214,933	531	0.33	%
Time, under \$100,000	35,137	104	0.40	%	40,035	155	0.52	%
Time, \$100,000 and over	54,859	206	0.50	%	60,511	376	0.83	%
FHLB advances and other borrowings	1	—	—	%	4,599	141	4.08	%
Total average interest-bearing liabilities	508,959	952	0.25	%	485,823	1,446	0.40	%
Non-interest-bearing liabilities:								
Non-interest-bearing demand								
deposits	249,351				209,087			
Interest payable and other liabilities	7,930				7,120			
Total liabilities	766,240				702,030			
Total average stockholders' equity	84,707				89,743			
Total average liabilities and stockholders' equity	\$850,947				\$791,773			
		\$20,399	3.42	%		\$19,711	3.57	%

Net interest income and net
interest margin (3)

1. Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-accrued interest thereon is excluded. Loan interest income includes loan fees of approximately \$1,021 and \$711 for the nine months ended September 30, 2013 and 2012, 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 \$11,415,000 decrease in cash and cash equivalents, a \$2,516,000 increase in investment securities available-for-sale, a \$56,807,000 increase in net loans held-for-investment, a \$2,768,000 decrease in loans held-for-sale, a \$1,062,000 decrease in other real estate owned, and a \$669,000 increase in interest receivable and other assets from December 31, 2012 to September 30, 2013. The decrease in cash and cash equivalents was due to a decrease in interest bearing due from bank accounts, partially offset by an increase in non-interest bearing due from bank accounts. The increase in investment securities available-for-sale was primarily the result of purchases of municipal bonds, agency bonds, and mortgage backed securities, partially offset by calls and maturities of U.S. government agencies and municipal bonds and amortization on mortgage backed securities. The increase in loans held-for-investment was due to increases in the following loan categories as a result of increased loan demand: commercial and industrial; equipment; financed equipment leases; true equipment leases; real estate; real estate commercial and construction. The increase in loans held-for-investment was partially offset by decreases in the following loan categories: agricultural; consumer; real estate; home equity lines. The decrease in loans held-for-sale was due to timing of sales of loans held-for-sale. The decrease in other real estate owned was due to the sale of three other real estate owned properties. The increase in interest receivable and other assets was mainly due to increases in accrued income on loans, income taxes receivable, cash surrender value of bank owned life insurance, unamortized loan costs, and mortgage servicing asset, which was partially offset by decreases in accrued income on securities, housing tax credits, prepaid expenses, and suspense & holdovers.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of \$52,703,000 from December 31, 2012 to September 30, 2013. The increase in deposits was due to increases in demand deposits, interest-bearing transaction deposits, savings accounts, and money market accounts, which was partially offset by decreases in time deposits.

CHANGES IN RESULTS OF OPERATIONS

Interest Income

The Federal Open Market Committee made no changes to the Federal Funds rate during the nine-month period ended September 30, 2013.

Interest income on loans for the nine-month period ended September 30, 2013 was up 2.3% from the same period in 2012, increasing from \$18,245,000 to \$18,671,000 and was up 4.1% for the three-month period ended September 30, 2013 over the same period in 2012, increasing from \$6,211,000 to \$6,466,000. The increase in interest income on loans for the nine-month period ended September 30, 2013 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 17 basis point decrease in loan yields. The increase in interest income on loans for the three-month period ended September 30, 2013 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 21 basis point decrease in loan yields. The decrease in loan yields was primarily due to the origination of new loans and the repricing of existing loans at lower rates.

Interest income on investment securities available-for-sale for the nine-month period ended September 30, 2013 was down 14.6% from the same period in 2012, decreasing from \$2,644,000 to \$2,259,000 and was down 16.2% for the three-month period ended September 30, 2013 over the same period in 2012, decreasing from \$859,000 to \$720,000. The decrease in interest income on investment securities for the nine-month period ended September 30, 2013 as compared to the same periods a year ago was primarily due to a 38 basis point decrease in investment securities yields, partially offset by an increase in average investment securities. The decrease in interest income on investment securities for the three-month period ended September 30, 2013 as compared to the same periods a year ago was primarily due to a 35 basis point decrease in investment securities yields, partially offset by an increase in average investment securities. The decrease in investment securities yields was primarily due to reinvestment of cash flows from the securities portfolio at lower rates.

Interest income on interest-bearing due from banks for the nine-month period ended September 30, 2013 was up 25.5% from the same period in 2012, increasing from \$251,000 to \$315,000 and was up 33.8% for the three-month period ended September 30, 2013 over the same period in 2012, increasing from \$77,000 to \$103,000. The increase in interest income on interest-bearing due from banks for the nine-month period ended September 30, 2013 as compared to the same period a year ago was due to an increase in average interest-bearing due from banks and a 1 basis point increase in interest bearing due from banks yield. The increase in interest income on interest-bearing due from banks for the three-month period ended September 30, 2013 as compared to the same period a year ago was due to an increase in average interest-bearing due from banks and a 2 basis point increase in interest bearing due from banks yield.

The Company had no Federal Funds sold balances during the three-month and nine-month periods ended September 30, 2013 and September 30, 2012.

Interest Expense

The sustained low interest rate environment decreased the Company's cost of funds in the first nine months of 2013 compared to the same period a year ago.

Interest expense on deposits and other borrowings for the nine-month period ended September 30, 2013 was down 34.2% from the same period in 2012, decreasing from \$1,446,000 to \$952,000 and was down 18.4% for the for the three-month period ended September 30, 2013 over the same period in 2012, from \$375,000 to \$306,000. The decrease in interest expense during the nine-month period ended September 30, 2013 was due to a 15 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The decrease in interest expense during the three-month period ended September 30, 2013 was due to a 7 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in average interest-bearing liabilities. The Company had no FHLB advances and related interest expense during the three-month and nine-month periods ended September 30, 2013. Interest expense on FHLB advances, included in interest expense on deposits and other borrowings, for the three-month and nine-month periods ended September 30, 2012 was \$0 and \$141,000, respectively.

Provision for Loan Losses

There was a provision for loan losses of \$800,000 for the nine-month period ended September 30, 2013 compared to a provision for loan losses of \$2,051,000 for the same period in 2012. There was a provision for loan losses of \$0 for the three-month period ended September 30, 2013 compared to a provision for loan losses of \$825,000 for the same period in 2012. The allowance for loan losses was approximately \$8,792,000, or 1.74% of total loans, at September 30, 2013 compared to \$8,554,000, or 1.91% of total loans, at December 31, 2012. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

The decrease in the provision for loan losses during the three-month and nine-month periods in 2013 was primarily due to decreased net charge-offs, partially offset by increased loan volumes compared to the same periods in 2012.

Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the three-month and nine-month periods ended September 30, 2013 and September 30, 2012.

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

Other Operating Income

Other operating income was up 9.9% for the nine-month period ended September 30, 2013 from the same period in 2012, increasing from \$6,772,000 to \$7,443,000.

This increase was primarily due to increases in investment and brokerage services income, loan servicing income, fiduciary activities income, and signature based transaction fees, which was partially offset by decreases in service charges on deposit accounts, gains on sales of other real estate owned, gains on sales of loans held-for-sale, mortgage brokerage income, and ATM fees. The increase in investment and brokerage services income and fiduciary activities income was primarily due to an increase in the demand for those services as well as an increase in the market value of investment and brokerage and fiduciary assets. The increase in loan servicing income was primarily due to an increase in mortgage servicing assets booked and the reversal of mortgage servicing impairment expense. The increase in signature based transaction fees was primarily due to an increase in the volume of transactions. The decrease in service charges on deposit accounts was primarily due to a decrease in service charges on checking accounts. The decrease in gains on sales of other real estate owned was primarily due to a decrease in the number of properties sold. The decrease in gains on sales of loans held-for-sale was due to an increase in market interest rates, partially offset by an increase in sales volume. The decrease in mortgage brokerage income was primarily due to a decrease in the demand for those services. The decrease in ATM fees was primarily due to a decrease in the volume of transactions.

Other operating income was down 1.4% for the three-month period ended September 30, 2013 from the same period in 2012, decreasing from \$2,306,000 to \$2,273,000.

This decrease was primarily due to decreases in service charges on deposit accounts, gains on sales of loans held-for-sale, and ATM fees, which was partially offset by increases in investment and brokerage services income, loan servicing income, fiduciary activities income, and signature based transaction fees. The decrease in service charges on deposit accounts was primarily due to a decrease in service charges on checking accounts. The decrease in gains on sales of loans held-for-sale was due to decreased sales volume and an increase in market interest rates. The decrease in ATM fees was primarily due to a decrease in the volume of transactions. The increase in investment and brokerage services income and fiduciary activities income was primarily due to an increase in the demand for those services as well as an increase in the market value of investment and brokerage and fiduciary assets. The increase in loan servicing income was primarily due to an increase in mortgage servicing assets booked and the reversal of mortgage servicing impairment expense. The increase in signature based transaction fees was primarily due to an increase in the volume of transactions.

Other Operating Expenses

Total other operating expenses were up 5.4% for the nine-month period ended September 30, 2013 from the same period in 2012, increasing from \$19,488,000 to \$20,530,000.

The increase was primarily due to increases in salaries and employee benefits, occupancy and equipment expense, data processing, and stationery and supplies, which was partially offset by decreases in advertising expense, other real estate owned expense and impairment, and other expenses. The increase in salaries and employee benefits was primarily due to increases in regular salaries, commissions, contingent compensation, and profit sharing expense. The increase in occupancy and equipment expense was primarily due to increases in rent expense and service contracts. The increase in data processing was primarily due to increases in contract pricing. The decrease in advertising was due to decreases in printed materials and related costs. The decrease in other real estate owned expense and impairment was due to a decrease in write-downs and maintenance expense. The decrease in other expenses was primarily due to decreases in loan origination expense, loan collection expense, and legal fees, which was partially offset by an increase in consulting fees.

Total other operating expenses were up 7.0% for the three-month period ended September 30, 2013 from the same period in 2012, increasing from \$6,470,000 to \$6,925,000.

The increase was primarily due to increases in salaries and employee benefits, occupancy and equipment expense, data processing, and advertising, which was partially offset by decreases in other real estate owned expense and impairment and other expenses. The increase in salaries and employee benefits was primarily due to increases in regular salaries, contingent compensation, and profit sharing expense. The increase in occupancy and equipment expense is primarily due to increases in rent expense and a decrease in solar utility rebates. The increase in data processing was primarily due to increases in contract pricing. The increase in advertising was due to increases in printed materials and related costs. The decrease in other real estate owned expense and impairment was due to a decrease in write-downs and maintenance expense. The decrease in other expenses was primarily due to a decrease in loan origination expense.

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The following table sets forth other miscellaneous operating expenses by category for the three-month and nine-month periods ended September 30, 2013 and 2012.

	(in thousands)			
	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine Months Ended September 30, 2013	Nine months ended September 30, 2012
Other miscellaneous operating expenses				
FDIC assessments	\$145	\$159	\$445	\$433
Contributions	35	28	85	80
Legal fees	37	41	119	168
Accounting and audit fees	67	71	235	217
Consulting fees	121	114	510	339
Postage expense	56	46	229	214
Telephone expense	32	38	126	136
Public relations	61	55	157	149
Training expense	32	36	96	91
Loan origination expense	91	306	350	594
Computer software depreciation	29	34	89	110
Sundry losses	—	(27)	17	14
Loan collection expense	24	23	56	134
Other miscellaneous expense	390	360	1,123	1,050
Total other miscellaneous operating expenses	\$1,120	\$1,284	\$3,637	\$3,729

Income Taxes

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

In the nine months ended September 30, 2013, the Company's expense for income taxes increased \$893,000 from the same period last year, from \$1,441,000 to \$2,334,000.

In the three months ended September 30, 2013, the Company's expense for income taxes increased \$420,000 from the same period last year, from \$584,000 to \$1,004,000.

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

Off-Balance Sheet Commitments

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

	(in thousands)	
	September 30, 2013	December 31, 2012
Undisbursed loan commitments	\$172,755	\$159,329
Standby letters of credit	2,387	2,376
Commitments to sell loans	1,977	7,480
	\$177,119	\$169,185

The reserve for unfunded lending commitments amounted to \$793,000 at September 30, 2013 and December 31, 2012, respectively. The reserve for unfunded lending commitments is included in other liabilities on the Consolidated Balance Sheets.

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.

The following tables summarize the Company's non-accrual loans net of guarantees of the State of California and U.S. Government by loan category at September 30, 2013 and December 31, 2012.

	At September 30, 2013			At June 30, 2013		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
(dollars in thousands)						
Residential mortgage	\$2,216	\$—	\$2,216	\$2,379	\$—	\$2,379
Residential construction	99	—	99	104	—	104
Commercial real estate	1,943	81	1,862	2,467	88	2,379
Agriculture	—	—	—	—	—	—
Commercial	2,633	97	2,536	2,612	—	2,612
Consumer	231	39	192	215	42	173
Total non-accrual loans	\$7,122	\$217	\$6,905	\$7,777	\$130	\$7,647

	At March 31, 2013			At December 31, 2012		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
(dollars in thousands)						
Residential mortgage	\$1,940	\$—	\$1,940	\$2,095	\$—	\$2,095
Residential construction	—	—	—	—	—	—
Commercial real estate	1,840	—	1,840	1,879	—	1,879
Agriculture	—	—	—	—	—	—
Commercial	2,747	46	2,701	2,853	73	2,780

Consumer	282	46	236	441	50	391
Total non-accrual loans	\$6,809	\$92	\$6,717	\$7,268	\$123	\$7,145

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 \$7,122,000 at September 30, 2013 and were comprised of seven residential mortgage loans totaling \$2,216,000, two residential construction loans totaling \$99,000, five commercial real estate loans totaling \$1,943,000, nine commercial loans totaling \$2,633,000 and five consumer loans totaling \$231,000. Non-accrual loans amounted to \$7,268,000 at December 31, 2012 and were comprised of seven residential mortgage loans totaling \$2,095,000, five commercial real estate loans totaling \$1,879,000, eleven commercial loans totaling \$2,853,000 and seven consumer loans totaling \$441,000. It is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral.

The five largest non-accrual loans as of September 30, 2013, totaled approximately \$4,593,000 or 64% of total non-accrual loans and consisted of two commercial real estate loans totaling \$1,648,000, supported by commercial properties located within the Company's market area, two residential mortgage loans totaling \$1,354,000, supported by residential properties located within the Company's market area and one commercial and industrial loan totaling \$1,591,000, supported by the business assets of the borrower. The collateral securing these loans is generally appraised every six months.

In comparison, the five largest non-accrual loans as of December 31, 2012, totaled approximately \$4,889,000 or 67% of total non-accrual loans and consisted of two residential mortgage loan totaling \$1,466,000, supported by residential property located within the Company's market area, two commercial real estate loans totaling \$1,665,000, supported by commercial properties located within the Company's market area and one commercial and industrial loan totaling \$1,758,000, supported by the business assets of the borrower.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Non-performing impaired loans are non-accrual loans and loans that are 90 days or more past due and still accruing. Total non-performing impaired loans at September 30, 2013 and December 31, 2012 consisting of loans on non-accrual status totaled \$7,122,000 and \$7,268,000, respectively. A restructuring of a loan can constitute a troubled debt restructuring if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A loan that is restructured in a troubled debt restructuring is considered an impaired loan. Performing impaired loans totaled \$6,871,000 and \$6,113,000 at September 30, 2013 and December 31, 2012, respectively. Performing impaired loans at September 30, 2013 consist of loans modified as troubled debt restructurings totaling \$6,798,000 and other impaired loans totaling \$73,000 on which the Company expects to collect all principal and interest due and are performing satisfactorily. These loans are not on non-accrual status. The majority of the non-performing impaired loans in management's opinion were adequately collateralized based on recently obtained appraised property values or guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

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As the following table illustrates, total non-performing assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored enterprises, decreased \$1,302,000, or 15.9% to \$6,905,000 during the first nine months of 2013. Non-performing assets, net of guarantees, represent 0.8% of total assets at September 30, 2013.

	At September 30, 2013			At June 30, 2013			
	Gross	Guaranteed	Net	Gross	Guaranteed	Net	
(dollars in thousands)							
Non-accrual loans	\$7,122	\$217	\$6,905	\$7,777	\$130	\$7,647	
Loans 90 days past due and still accruing	—	—	—	—	—	—	
Total non-performing loans	7,122	217	6,905	7,777	130	7,647	
Other real estate owned	—	—	—	—	—	—	
Total non-performing assets	7,122	217	6,905	7,777	130	7,647	
Non-performing loans to total loans			1.4	%		1.6	%
Non-performing assets to total assets			0.8	%		0.9	%
Allowance for loan and lease losses to non-performing loans			127.3	%		114.1	%

	At March 31, 2013			At December 31, 2012			
	Gross	Guaranteed	Net	Gross	Guaranteed	Net	
(dollars in thousands)							
Non-accrual loans	\$6,809	\$92	\$6,717	\$7,268	\$123	\$7,145	
Loans 90 days past due and still accruing	—	—	—	—	—	—	
Total non-performing loans	6,809	92	6,717	7,268	123	7,145	
Other real estate owned	1,062	—	1,062	1,062	—	1,062	
Total non-performing assets	7,871	92	7,779	8,330	123	8,207	
Non-performing loans to total loans			1.5	%		1.6	%
Non-performing assets to total assets			0.9	%		1.0	%
Allowance for loan and lease losses to non-performing loans			131.7	%		119.7	%

The Company had no loans 90 days past due and still accruing at September 30, 2013 and December 31, 2012.

Other real estate owned (OREO) consists of property that the Company has acquired by deed in lieu of foreclosure or through foreclosure proceedings, and property that the Company does not hold title to but is in actual control of, known as in-substance foreclosure. The estimated fair value of the property is determined prior to transferring the balance to OREO. The balance transferred to OREO is the estimated fair value of the property less estimated cost to sell. Impairment may be deemed necessary to bring the book value of the loan equal to the appraised value. Appraisals or loan officer evaluations are then conducted periodically thereafter charging any additional impairment to the appropriate expense account.

OREO amounted to \$0 and \$1,062,000 as of September 30, 2013 and December 31, 2012, 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 Allowance for Loan Losses of the Company during the nine-month periods ended September 30, 2013 and 2012, and for the year ended December 31, 2012.

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

	Nine months ended September 30,		Year ended December 31,
	2013	2012	2012
Balance at beginning of period	\$8,554	\$10,408	\$10,408
Provision for loan losses	800	2,051	3,276
Loans charged-off:			
Commercial	(113)	(1,104)	(3,498)
Commercial Real Estate	(3)	(346)	(375)
Agriculture	(1)	(115)	(116)
Residential mortgage	(333)	(864)	(864)
Residential construction	(127)	(161)	(167)
Consumer loans to individuals	(491)	(668)	(875)
Total charged-off	(1,068)	(3,258)	(5,895)
Recoveries:			
Commercial	149	278	306
Commercial Real Estate	51	—	—
Agriculture	3	3	4
Residential mortgage	157	—	—
Residential construction	44	260	341
Consumer loans to individuals	102	75	114
Total recoveries	506	616	765
Net charge-offs	(562)	(2,642)	(5,130)
Balance at end of period	\$8,792	\$9,817	\$8,554
Ratio of net charge-offs to average loans outstanding during the period (annualized)	(0.16 %)	(0.60 %)	(1.18 %)
Allowance for loan losses To total loans at the end of the period	1.74 %	2.16 %	1.91 %

To non-performing loans, net of guarantees at the end of the period	127.3	%	111.8	%	119.7	%
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Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2013, the Company had the following deposit mix: 30.3% in savings and MMDA deposits, 11.3% in time deposits, 25.4% in interest-bearing transaction deposits and 33.0% in non-interest-bearing transaction deposits. At December 31, 2012, the Company had the following deposit mix: 30.5% in savings and MMDA deposits, 12.6% in time deposits, 25.3% in interest-bearing transaction deposits and 31.6% in non-interest-bearing transaction deposits. Non-interest-bearing transaction deposits increase the Company's net interest income by lowering its cost of funds.

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

Maturities of time certificates of deposits of \$100,000 or more outstanding at September 30, 2013 and December 31, 2012 are summarized as follows:

	(in thousands)	
	September 30, 2013	December 31, 2012
Three months or less	\$16,847	\$17,159
Over three to twelve months	25,989	30,361
Over twelve months	11,670	8,953
Total	\$54,506	\$56,473

The decrease in time certificates of deposit (CD's) of \$100,000 or more is primarily attributable to the maturities of time deposits.

Liquidity and Capital Resources

In order to serve our market area, the Company must maintain adequate liquidity and adequate capital. Liquidity is measured by various ratios, in management's opinion, the most common being the ratio of net loans to deposits (including loans held-for-sale). This ratio was 63.7% on September 30, 2013. In addition, on September 30, 2013, the Company had the following short-term investments (based on remaining maturity and/or next repricing date): \$2,202,000 in securities due within one year or less; and \$38,178,000 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 \$37,000,000 at September 30, 2013. Additionally, the Company has a line of credit with the Federal Home Loan Bank (the "FHLB"), with a borrowing capacity at September 30, 2013 of \$159,264,000; credit availability is subject to certain collateral requirements.

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

As of September 30, 2013, the Bank's capital ratios exceeded applicable regulatory requirements. The following table presents the capital ratios for the Bank, compared to the regulatory standards for well-capitalized depository institutions, as of September 30, 2013.

(amounts in thousands except percentage
amounts)

	Actual		Well Capitalized Ratio Requirement		
	Capital	Ratio			
Leverage	\$77,699	9.01	%	5.0	%
Tier 1 Risk-Based	\$77,699	14.16	%	6.0	%
Total Risk-Based	\$84,592	15.42	%	10.0	%

In July 2013, the Federal Reserve Board and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations and to conform this framework to the Basel Committee's current international regulatory capital accord (Basel III). These rules, upon their effectiveness, will replace the federal banking agencies' general risk-based capital rules, advanced approaches rule, market-risk rule, and leverage rules, in accordance with certain transition provisions. Banks, such as First Northern Bank, will become subject to the new rules on January 1, 2015. The new rules implement higher minimum capital requirements, include a new common equity Tier 1 capital requirement, and establish criteria that instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. When fully phased in, the final rules will provide for increased minimum capital ratios as follows: (a) a common equity Tier 1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (which is an increase from 4.0%); (c) a total capital ratio of 8%; and (d) a Tier 1 leverage ratio to average consolidated assets of 4%. Under the new rules, in order to avoid certain limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk based capital requirements (equal to 2.5% of total risk-weighted assets). The phase-in of the capital conservation buffer will begin January 1, 2016, and be completed by January 1, 2019. The new rules also provide for various adjustments and deductions to the definitions of regulatory capital that will phase in from January 1, 2014 to December 31, 2017. We are currently evaluating the impact of these changes on our future regulatory capital position.

ITEM 3. – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET

The Company believes that there have been no material changes in the quantitative and qualitative disclosures about market risk as of September 30, 2013, from those presented in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012, which are incorporated by reference herein.

ITEM 4. – CONTROLS AND PROCEDURES

(a) We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) have concluded that the design and operation of our disclosure controls and procedures are effective as of September 30, 2013. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended September 30, 2013, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. – LEGAL PROCEEDINGS

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

ITEM 1A. – RISK FACTORS

There are no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012 and our Quarterly Report on Form 10-Q for the three months ended June 30, 2013. See Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2012, entitled “Risk Factors,” and Part II, Item 1A in our Quarterly Report on Form 10-Q for the three months ended June 30, 2013, entitled “Risk Factors.”

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

None.

ITEM 3. – DEFAULTS UPON SENIOR SECURITIES

None.

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ITEM 4. – MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. – OTHER INFORMATION

None.

ITEM 6. – EXHIBITS

Exhibit Number	Description of Document
31.1	Rule 13a — 14(a) Certification of Chief Executive Officer
31.2	Rule 13a — 14(a) Certification of Chief Financial Officer
32.1*	Statement of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
32.2*	Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
101	Pursuant to Rule 405 of Regulation S-T, the following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2013, is formatted in XBRL interactive data files: (i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Comprehensive (Loss) Income (iv) Condensed Consolidated Statement of Stockholders' Equity; (v) Condensed Consolidated Statements of Cash Flows; and (vi) Notes to Condensed Consolidated Financial Statements.

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

SIGNATURES

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

FIRST NORTHERN COMMUNITY BANCORP

Date: November 7, 2013 By: /s/ Jeremiah Z. Smith

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