FIRST NORTHERN COMMUNITY BANCORP
Form 10-Q
May 12, 2011

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

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2011

OR

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

For the transition period from _______________ to _______________

Commission File Number 000-30707

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

California	68-0450397
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
195 N. First Street, Dixon, California	95620
(Address of principal executive offices)	(Zip Code)

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

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

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

Yes ¨ No x

The number of shares of Common Stock outstanding as of May 12, 2011 was 9,116,316.

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PART I – FINANCIAL INFORMATION

FIRST NORTHERN COMMUNITY BANCORP

ITEM I – FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands, except shares and share amounts)	March 31, 2011 (unaudited)	December 31, 2010
Assets		
Cash and due from banks	$152,368	$139,707
Investment securities – available-for-sale	125,838	107,346
Loans, net of allowance for loan losses of $11,712 at March 31, 2011 and $11,039 at December 31, 2010	420,698	442,015
Loans held-for-sale	3,038	2,345
Stock in Federal Home Loan Bank and other equity securities, at cost	2,823	2,823
Premises and equipment, net	8,030	8,035
Other real estate owned	2,664	2,682
Interest receivable and other assets	33,364	32,264
Total Assets	$748,823	$737,217
Liabilities and Stockholders’ Equity		
Liabilities:		
Demand deposits	$186,422	$180,382
Interest-bearing transaction deposits	148,102	146,579
Savings and MMDA's	210,759	204,360
Time, under $100,000	40,120	40,083
Time, $100,000 and over	65,864	68,854
Total deposits	651,267	640,258
Federal Home Loan Bank advances and other borrowings	10,500	10,529
Interest payable and other liabilities	6,831	6,834
Total liabilities	668,598	657,621
Stockholders' Equity:		
Preferred stock, par value $0.01 per share; $1,000 per share liquidation preference, 18,500 shares authorized; 17,390 shares issued and outstanding at March 31, 2011 and December 31, 2010	16,976	16,944
Common stock, no par value; 16,000,000 shares authorized; 9,116,316 shares issued and outstanding at March 31, 2011 and 9,103,158 shares issued and outstanding at December 31, 2010	62,909	62,869

Additional paid in capital	977	977
Retained earnings (accumulated deficit)	116	(401)
Accumulated other comprehensive loss, net	(753)	(793)
Total stockholders' equity	80,225	79,596
Total Liabilities and Stockholders' Equity	$748,823	$737,217

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands, except per share amounts)	Three months ended March 31, 2011	Three months ended March 31, 2010
Interest and Dividend Income:		
Loans	$6,257	$6,798
Due from banks interest bearing accounts	85	94
Investment securities		
Taxable	570	375
Non-taxable	111	235
Total interest and dividend income	7,023	7,502
Interest Expense:		
Deposits	571	1,004
Other borrowings	90	107
Total interest expense	661	1,111
Net interest income	6,362	6,391
Provision for loan losses	990	1,450
Net interest income after provision for loan losses	5,372	4,941
Other operating income:		
Service charges on deposit accounts	693	825
Gains on sales of other real estate owned	196	27
Gains on sales of loans held-for-sale	137	117
Investment and brokerage services income	245	244
Mortgage brokerage income	12	8
Loan servicing income	335	272
Fiduciary activities income	97	70
ATM fees	101	62
Signature based transaction fees	210	173
Other income	161	205
Total other operating income	2,187	2,003
Other operating expenses:		
Salaries and employee benefits	3,773	3,768
Occupancy and equipment	823	847
Data processing	384	448
Stationery and supplies	75	81
Advertising	137	131
Directors’ fees	64	52
Other real estate owned expense and impairment	206	231
Other expense	1,222	1,315
Total other operating expenses	6,684	6,873
Income before income tax expense (benefit)	875	71
Income tax expense (benefit)	109	(290)

Net income	$766	$361
Preferred stock dividends and accretion	$(249)	$(246)
Net income available to common shareholders	$517	$115
Basic income per share	$0.06	$0.01
Diluted income per share	$0.06	$0.01

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

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

(in thousands, except share data)

	Preferred Stock Shares	Preferred Stock Amounts	Common Stock Shares	Common Stock Amounts	Comprehensive Income	Additional Paid-in Capital	(Accumulated Deficit)/ Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2010	17,390	$16,944	9,103,158	$62,869		$977	$ (401)	$ (793)	$79,596
Comprehensive income:									
Net income					$ 766		766		766
Other comprehensive income, net of tax:									
Unrealized holding gains on securities arising during the current period, net of tax effect of $26					40				
Total other comprehensive income, net of tax effect of $26					40			40	40
Comprehensive income					$ 806				
Dividend on preferred stock							(217)		(217)
Discount accretion on preferred stock		32					(32)		—

Stock-based compensation and related tax benefits				40				40
Common shares issued			13,158					
Balance at March 31, 2011	17,390	$16,976	9,116,316	$62,909	$977	$ 116	$ (753)	$80,225

See notes to unaudited condensed consolidated financial statements.

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FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	(in thousands) Three months ended March 31, 2011	Three months ended March 31, 2010
Cash Flows From Operating Activities		
Net Income	$766	$ 361
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	183	215
Provision for loan losses	990	1,450
Stock plan accruals	40	67
Gains on sales of other real estate owned	(196)	(27)
Impairment on other real estate owned	71	144
Gains on sales of loans held-for-sale	(137)	(117)
Proceeds from sales of loans held-for-sale	6,259	9,614
Originations of loans held-for-sale	(6,815)	(9,458)
Changes in assets and liabilities:		
(Increase) decrease in interest receivable and other assets	(1,127)	1,058
Decrease in interest payable and other liabilities	(3)	(161)
Net cash provided by operating activities	31	3,146
Cash Flows From Investing Activities		
Net increase in investment securities	(18,425)	(20,464)
Net decrease in loans	19,629	21,474
Proceeds from the sale of other real estate owned	841	12
Purchases of premises and equipment, net	(178)	(32)
Net cash provided by investing activities	1,867	990
Cash Flows From Financing Activities		
Net increase (decrease) in deposits	11,009	(541)
Net (decrease) increase in FHLB advances and other borrowings	(29)	16
Cash dividends paid on preferred stock	(217)	(217)
Net cash provided by (used) in financing activities	10,763	(742)
Net Increase in Cash and Cash Equivalents	12,661	3,394
Cash and Cash Equivalents, beginning of period	139,707	147,076
Cash and Cash Equivalents, end of period	$152,368	$ 150,470
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$663	$ 1,148
Supplemental disclosures of non-cash investing and financing activities:		
Preferred stock dividend payable and accretion	$143	$ 140
Transfer of loans held-for-investment to other real estate owned	$894	$ 888

Unrealized holding gains on available for sale securities, net of taxes	$40	$ 320

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011 and 2010 and December 31, 2010

1. BASIS OF PRESENTATION

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

Recently Issued Accounting Pronouncements:

In January 2010, FASB amended FASB ASC Topic 820, "Fair Value Measurements and Disclosures." This amendment requires disclosures about significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers, and requires the reconciliation of activity in Level 3 fair value measurements be made on a gross basis. The amendment also clarifies the level of disaggregation required in disclosures and the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for Level 2 or Level 3 items. The part of the amendment related to the reconciliation of Level 3 activity is effective for interim and annual periods beginning after December 15, 2010. The remaining parts of the amendment are effective for interim and annual periods beginning after December 15, 2009. The Company adopted the amendment on January 1, 2010 and adopted the part of the amendment related to the reconciliation of Level 3 activity on January 1, 2011. Adoption of the new guidance did not significantly impact the Company's consolidated financial statements.

In July 2010, FASB amended FASB ASC Topic 310, "Receivables." This amendment modifies the disclosures that an entity provides about the credit quality of its financing receivables and the related allowance for credit losses. As a result of these amendments, an entity is required to disaggregate, by portfolio segment or class of financing receivable, certain existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses. The disclosures are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. Adoption of the new guidance did not have a significant impact on the Company's consolidated financial statements.

In January 2011, FASB issued Accounting Standards Update (ASU) 2011-01. This update temporarily delays the effective date of the disclosures about troubled debt restructurings required in FASB ASC Topic 310, "Receivables." The effective date of the disclosures about troubled debt restructurings for public entities is currently anticipated to be effective for interim and annual periods ending after June 15, 2011.

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

2. LOANS

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

($ in thousands)	March 31, 2011	December 31, 2010
Commercial	$76,179	$82,815
Commercial Real Estate	186,820	186,405
Agriculture	41,427	53,040
Residential Mortgage	51,420	52,347
Residential Construction	8,819	10,246
Consumer	67,859	68,374
	432,524	453,227
Allowance for loan losses	(11,712)	(11,039)
Net deferred origination fees and costs	(114)	(173)
Loans, net	$420,698	$442,015

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

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

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

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

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

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

Consumer loans, whether unsecured or secured are primarily susceptible to 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 due to loss of employment and will follow general economic trends in the marketplace, particularly the upward movements in the unemployment rate, loss of collateral value, and demand shifts.

As of March 31, 2011, approximately 43% in principal amount of the Company's loans were for commercial real estate, which consists of construction and land development loans and real estate loans. Approximately 12% of the Company's loans were residential mortgage loans. Approximately 2% of the Company's loans were residential construction loans. Approximately 28% of the Company's loans were for general commercial uses including professional, retail, agriculture and small businesses. Approximately 15% of the Company's loans were consumer loans.

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

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

Non-accrual and Past Due Loans

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

($ in thousands)	March 31, 2011	December 31, 2010
Commercial	$1,575	$1,817
Commercial Real Estate	5,748	5,864
Agriculture	1,752	1,752
Residential Mortgage	2,264	2,301
Residential Construction	511	272
Consumer	396	268
	$12,246	$12,274

Non-accrual loans amounted to $12,246,000 at March 31, 2011 and were comprised of seven residential mortgage loans totaling $2,264,000, four residential construction loans totaling $511,000, eight commercial real estate loans totaling $5,748,000, one agricultural loan totaling $1,752,000, six commercial loans totaling $1,575,000 and five consumer loans totaling $396,000. Non-accrual loans amounted to $12,274,000 at December 31, 2010 and were comprised of seven residential mortgage loans totaling $2,301,000, four residential construction loans totaling $272,000, nine commercial real estate loans totaling $5,864,000, one agricultural loan totaling $1,752,000, ten commercial loans totaling $1,817,000 and five consumer loans totaling $268,000. It is generally the Company’s policy to charge-off the portion of any non-accrual loan for which the Company does not expect to collect by writing the loan down to fair value.

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

($ in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans
March 31, 2011						
Commercial	$301	$—	$1,527	$1,828	$74,351	$76,179
Commercial Real Estate	1,443	201	4,273	5,917	180,903	186,820
Agriculture	—	—	1,752	1,752	39,675	41,427
Residential Mortgage	281	—	1,148	1,429	49,991	51,420
Residential Construction	—	—	63	63	8,756	8,819
Consumer	72	2	263	337	67,522	67,859
Total	$2,097	$203	$9,026	$11,326	$421,198	$432,524
December 31, 2010						
Commercial	$1,606	$193	$228	$2,027	$80,788	$82,815
Commercial Real Estate	1,270	1,974	3,767	7,011	179,394	186,405
Agriculture	—	—	1,751	1,751	51,289	53,040
Residential Mortgage	749	—	1,326	2,075	50,272	52,347
Residential Construction	462	—	63	525	9,721	10,246
Consumer	421	88	242	751	67,623	68,374
Total	$4,508	$2,255	$7,377	$14,140	$439,087	$453,227

The Company had no loans 90 days or more past due and still accruing at March 31, 2011 and December 31, 2010.

Impaired Loans

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

($ in thousands)	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
March 31, 2011					
Commercial	$ 2,632	$ 1,751	$ 985	$ 2,736	$ 60
Commercial Real Estate	7,304	5,748	1,223	6,971	22
Agriculture	2,783	1,752	381	2,133	41
Residential Mortgage	6,922	2,264	4,129	6,393	622
Residential Construction	2,426	511	1,478	1,989	604
Consumer	521	262	159	421	115
Total	$ 22,588	$ 12,288	$ 8,355	$ 20,643	$ 1,464
December 31, 2010					
Commercial	$ 3,725	$ 1,660	$ 1,334	$ 2,994	$ 89
Commercial Real Estate	7,414	5,864	1,224	7,088	22
Agriculture	2,785	1,752	383	2,135	41
Residential Mortgage	6,544	2,123	3,910	6,033	543
Residential Construction	2,058	272	1,349	1,621	575
Consumer	312	258	36	294	12
Total	$ 22,838	$ 11,929	$ 8,236	$ 20,165	$ 1,282

Impaired loans are loans for which it is probable that the Company will not be able to collect all amounts due. Non-performing impaired loans totaled approximately $12,246,000 and $12,274,000 at March 31, 2011 and December 31, 2010, respectively, and had related valuation allowances of approximately $160,000 and $95,000 at March 31, 2011 and December 31, 2010, respectively. Performing impaired loans are restructured loans in compliance with modified terms and totaled $8,397,000 and $7,891,000 at March 31, 2011 and December 31, 2010, respectively, and had related valuation allowances of approximately $1,304,000 and $1,187,000 at March 31, 2011 and December 31, 2010, respectively.

Interest income on impaired loans recognized during the three-month periods ended March 31, 2011 and 2010 was as follows:

($ in thousands)	Three Months Ended March 31, 2011		Three Months Ended March 31, 2010	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$ 2,865	$ 17	$ 4,234	$ 31
Commercial Real Estate	7,030	56	8,976	80

Agriculture	2,133	5	3,393	6
Residential Mortgage	6,213	47	5,522	51
Residential Construction	1,805	17	4,554	17
Consumer	358	3	199	—
Total	$20,404	$ 145	$26,878	$ 185

The average outstanding balance of non-performing impaired loans was approximately $12,260,000 and $18,065,000 for the three-month periods ended March 31, 2011 and March 31, 2010, respectively. Interest income recognized on non-performing impaired loans related to cash payments received was approximately $43,000 and $76,000 for the three-month periods ended March 31, 2011 and March 31, 2010, respectively. The average outstanding balance of performing impaired loans was approximately $8,144,000 and $8,813,000 for the three-month periods ended March 31, 2011 and March 31, 2010, respectively. Interest income recognized on performing impaired loans was approximately $102,000 and $109,000 for the three-month periods ended March 31, 2011 and March 31, 2010.

Credit Quality Indicators

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

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

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

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

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

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

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

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

Risk Rating “8” – Loss (Classified):

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

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

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

($ in thousands)	Pass	Special Mention	Substandard	Doubtful	Loss	Total
March 31, 2011						
Commercial	$54,057	$8,098	$12,904	$1,043	$77	$76,179
Commercial Real Estate	149,704	15,766	21,350	—	—	186,820
Agriculture	32,620	3,347	5,460	—	—	41,427
Residential Mortgage	42,508	281	8,631	—	—	51,420