Vaughan Foods, Inc.
Form 10-Q
August 10, 2007

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

# FORM 10-Q

(Mark One)

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

**For the quarterly period ended June 30, 2007**

**OR**

o **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 001-33446**

# VAUGHAN FOODS, INC.

(Exact name of registrant as specified in its charter)

| **Oklahoma** | **73-1342046** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **216 N.E. 12th Street, Moore, OK** | **73160** |
| (Address of principal executive offices) | (Zip Code) |

**(405) 794-2530**
(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 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 o No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes x No o

Number of shares outstanding of the registrant s common stock, as of August 7, 2007:

| Class | Shares Outstanding |
| --- | --- |
| Common Stock, $0.001 par value per share | 4,623,077 |

**VAUGHAN FOODS, INC.**
**Form 10-Q**
**For the Quarterly Period Ended June 30, 2007**
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## PART 1 FINANCIAL INFORMATION

### ITEM 1 FINANCIAL STATEMENTS.

**VAUGHAN FOODS, INC.**
Consolidated Balance Sheets
June 30, 2007 and December 31, 2006

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| | (unaudited) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 471,525 | $ 868,377 |
| Accounts receivable, net of allowance for doubtful accounts of $94,270 at June 30, 2007 and $65,045 at December 31, 2006 | 6,573,224 | 3,414,843 |
| Accounts receivable, related party | | 144,243 |
| Inventories | 2,452,663 | 631,674 |
| Prepaid expenses and other assets | 163,612 | 79,793 |
| Bridge loan asset, net of amortization | | 562,500 |
| Deferred tax assets | 23,727 | 24,717 |
| Total current assets | 9,684,751 | 5,726,147 |
| Restricted assets: | | |
| Cash | 277 | 270 |
| Investments | 813,959 | 597,181 |
| Certificate of deposit | 250,000 | 250,000 |
| Total restricted assets | 1,064,236 | 847,451 |
| Property and equipment, net | 16,602,506 | 13,102,988 |
| Other assets: | | |
| Assets held for sale | | 40,000 |
| Loan origination fees, net of amortization | 390,458 | 516,410 |
| Intangible assets | 865,461 | |
| Deferred tax assets, noncurrent | 148,994 | 202,119 |
| Deferred cost of public offering | 1,062,428 | 566,955 |
| Total other assets | 2,467,341 | 1,325,484 |
| Total assets | $ 29,818,834 | $ 21,002,070 |
| Liabilities and Stockholders Equity (Deficiency) | | |
| Current liabilities: | | |
| Accounts payable | $ 7,039,282 | $ 4,221,635 |
| Amounts payable to former owners of Allison s Gourmet Kitchens | 1,500,000 | |
| Accounts payable, related party | | 69,502 |

| | | |
|---|---|---|
| Disbursements in transit | 373,095 | |
| Line of credit | 2,726,578 | 2,726,578 |
| Short-term borrowings | 3,000,000 | 3,000,000 |
| Bridge funding liability | 1,125,000 | 1,125,000 |
| Note payable to former owners of Allison s Gourmet Kitchens | 1,000,000 | |
| Accrued liabilities | 2,174,297 | 1,011,985 |
| Current portion of long-term debt | 932,745 | 606,885 |
| Current portion of capital lease obligation | 181,052 | 172,370 |
| Amounts payable to former owners of Wild About Food | 500,000 | |
| Total current liabilities | 20,552,049 | 12,933,955 |
| Long term liabilities: | | |
| Long-term debt, net of current portion | 9,902,443 | 8,187,067 |
| Capital lease obligation, net of current portion | 393,868 | 479,618 |
| Amounts payable to former owners of Wild About Food, net of current portion | 126,780 | |
| Total long-term liabilities | 10,423,091 | 8,666,685 |
| Stockholders equity (deficiency): | | |
| Common stock, $0.001 par value; authorized 50,000,000 shares; 2,300,000 shares issued and outstanding at December 31, 2006 and June 30, 2007 | 2,300 | 2,300 |
| Preferred stock, $0.001 par value; authorized 5,000,000 shares; 0 shares issued and outstanding at December 31, 2006 and June 30, 2007 | | |
| Paid in Capital | 413,693 | 413,693 |
| Member Capital (deficit) | (28,748) | (22,921) |
| Retained Earnings (deficit) | (1,543,551) | (991,642) |
| Total stockholders equity (deficiency) | (1,156,306) | (598,570) |
| Total liabilities and stockholders equity (deficiency) | $ 29,818,834 | $ 21,002,070 |

The accompanying notes are an integral part of these consolidated financial statements.

**VAUGHAN FOODS, INC.**

Unaudited Consolidated Statements of Operations

For the Three Months and Six Months Ended June 30, 2007 and 2006

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (unaudited) | | | |
| Net sales | $ 13,945,725 | $ 13,820,293 | $ 26,478,941 | $ 26,317,960 |
| Cost of sales | 12,858,724 | 13,677,419 | 24,005,232 | 24,486,599 |
| Gross profit | 1,087,001 | 142,874 | 2,473,709 | 1,831,361 |
| Selling, general and administrative expenses | 969,755 | 1,177,009 | 1,803,200 | 2,206,912 |
| Operating income (loss) | 117,246 | (1,034,135) | 670,509 | (375,551) |
| Rent income | 124,624 | 83,850 | 219,805 | 166,425 |
| Interest expense | (777,932) | (253,333) | (1,396,967) | (516,387) |
| Loss on sale of asset | (21,486) | | (21,486) | |
| Interest and other income | 13,543 | 16,139 | 24,518 | 28,314 |
| Other income and expense, net | (661,251) | (153,344) | (1,174,130) | (321,648) |
| (Loss) before income taxes | (544,005) | (1,187,479) | (503,621) | (697,199) |
| Income tax expense (benefit) | (97,633) | (486,651) | 54,115 | (248,797) |
| Net (loss) | $ (446,372) | $ (700,828) | $ (557,736) | $ (448,402) |
| Weighted average shares outstanding - basic and diluted | 2,300,000 | 2,300,000 | 2,300,000 | 2,300,000 |
| Net income (loss) per share - basic and diluted | $ (0.19) | $ (0.30) | $ (0.24) | $ (0.19) |

The accompanying notes are an integral part of these consolidated financial statements.

**VAUGHAN FOODS, INC.**

Unaudited Consolidated Statements of Stockholders Equity

For the Year Ended December 31, 2006 and Six Months Ended June 30, 2007

| | Common Stock | | | | | |
|---|---|---|---|---|---|---|
| | Shares issued | Amount | Paid in Capital | Member Capital (Deficit) | Retained Earnings (Deficit) | Total Stockholders Equity (Deficiency) |
| Balance at January 1, 2006 | 2,300,000 | $ 2,300 | $ 413,693 | $ (12,839) | $ 202,784 | $ 605,938 |
| Net income (loss) | | | | (10,082) | (1,194,426) | (1,204,508) |
| Balance at December 31, 2006 | 2,300,000 | 2,300 | 413,693 | (22,921) | (991,642) | (598,570) |
| Net income (loss) (unaudited) | | | | (5,827) | (551,909) | (557,736) |
| Balance at June 30, 2007 (unaudited) | 2,300,000 | $ 2,300 | $ 413,693 | $ (28,748) | $ (1,543,551) | $ (1,156,306) |

The accompanying notes are an integral part of these consolidated financial statements.

**VAUGHAN FOODS, INC.**
Unaudited Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2007 and 2006

| | Six Months Ended June 30, | |
|---|---|---|
| | **2007** | **2006** |
| | (unaudited) | |
| Cash flows from operating activities: | | |
| Net (loss) | $ (557,736) | $ (448,402) |
| Adjustments to reconcile net (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,235,912 | 547,158 |
| Provision for bad debts | (2,605) | |
| Loss on sale of asset | 21,486 | |
| Deferred income taxes | 54,115 | (262,818) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (746,933) | (1,467,277) |
| Accounts receivable - related party | (210,085) | 33,585 |
| Inventories | (96,049) | 3,919 |
| Prepaid expenses and other assets | (58,775) | (81,368) |
| Disbursements in transit | | 83,859 |
| Accounts payable | 776,225 | 1,958,063 |
| Accounts payable, related party | (32,703) | |
| Accrued liabilities | 630,346 | 207,051 |
| Net cash provided by operating activities | 1,013,198 | 573,770 |
| Cash flows from investing activities: | | |
| Cash paid for property and equipment | (685,326) | (2,016,618) |
| Restricted assets | (216,785) | (118,681) |
| Proceeds from sale of assets | 18,514 | |
| Distributions from restricted assets | | 1,449,763 |
| Cash acquired in acquisition | 222,411 | |
| Net cash (used in) investing activities | (661,186) | (685,536) |
| Cash flows from financing activities: | | |
| Cash paid for deferred public offering expense | (495,473) | |
| Proceeds from long-term debt | | 90,140 |
| Proceeds from line of credit | | 500,000 |
| Repayment of long-term debt and capital leases | (253,391) | (440,473) |
| Net cash provided by (used in) financing activities | (748,864) | 149,667 |
| Net increase (decrease) in cash and cash equivalents | (396,852) | 37,901 |
| Cash and cash equivalents at beginning of period | 868,377 | 36,163 |
| Cash and cash equivalents at end of period | $ 471,525 | $ 74,064 |

| | | | | |
|---|---|---|---|---|
| Supplemental disclosures of cash flow information: | | | | |
| Cash paid during the period for: | | | | |
| Interest paid, net of capitalized interest | $ | 307,758 | $ | 494,554 |
| Supplemental disclosures of noncash financing and investing activities: | | | | |
| Fair value of assets acquired and liabilities assumed in acquisition: | | | | |
| Accounts receivable | $ | 2,054,514 | $ | |
| Inventories | | 1,724,940 | | |
| Prepaids | | 25,044 | | |
| Property and equipment | | 3,354,543 | | |
| Intangible assets | | 872,569 | | |
| Total assets acquired | $ | 8,031,610 | $ | |
| Accounts payable and accrued expenses | $ | 3,770,987 | $ | |
| Long-term debt and capital leases | | 1,983,034 | | |
| Total liabilities assumed | $ | 5,754,021 | $ | |

The accompanying notes are an integral part of these consolidated financial statements.

**Vaughan Foods, Inc.**
**Notes to Unaudited Consolidated Financial Statements**
June 30, 2007 and 2006

**(1) Nature of Operations**

Vaughan Foods, Inc. (the Company ) is an Oklahoma-based specialty food processor serving customers in a multi-state region. The Company and its subsidiaries operate from manufacturing facilities in Moore, Oklahoma and Fort Worth, Texas.

**(2) Summary of Significant Accounting Policies**

**(a) Basis of Reporting**

The accompanying financial statements and notes thereto have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain disclosures normally prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The accompanying financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s S-1 Registration Statement (Amendment No. 10).

This summary of significant accounting policies is presented to assist in understanding the Company s consolidated financial statements. The consolidated financial statements and notes are representations of the Company s management which is responsible for the integrity and objectivity of the consolidated financial statements. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the consolidated financial statements.

**(b) Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and of Cimarron Holdings, LLC ( Cimarron ). Cimarron is owned by the two individual stockholders of the Company prior to the initial public offering. Cimarron owns an airplane that is used by Company management. The Company is paying the debt service payments on the liability associated with the airplane, as well as all costs of maintenance and operations. Because the Company is the primary beneficiary of Cimarron, it is considered a variable interest entity subject to FIN 46R, and has been consolidated by the Company in its consolidated financial statements. All significant intercompany transactions and balances have been eliminated in consolidation. See Note 20 to the consolidated financial statements.

On June 30, 2007, the Company acquired 100 percent of Allison s Gourmet Kitchens, LP ( Allison s ) and its wholly-owned subsidiary, Wild About Food - Oklahoma, a Texas Limited Liability Company ( Wild ). The accompanying consolidated balance sheet as of June 30, 2007 includes the accounts of Allison s and Wild. All intercompany balances have been eliminated in consolidation.

**(c) Unaudited Interim Financial Information**

The financial information herein is unaudited; however, such information reflects solely normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. Operating results of the interim period are not necessarily indicative of the amounts that will be reported for the entire year.

**(d) Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, the Company considers investments with maturities of three months or less at date of purchase to be cash equivalents.

**(e) Accounts Receivable and Credit Policies**

Trade accounts receivable are customer obligations due under normal trade terms generally requiring payment within 15 to 21 days from the invoice date. Receivables are recorded based on the amounts invoiced to customers. Interest and delinquency fees are not generally assessed and, if they are assessed, are not included in income or trade accounts receivable until realized in cash. Discounts allowed for early payment, if any, are charged against income when the payment is received. Payments of accounts receivable are allocated to the specific invoices identified on the customer s remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of accounts receivable is reduced by an allowance for doubtful accounts that reflects management s best estimate of the amounts that will not be collected. Management provides for probable uncollectible amounts through a charge to earnings and a credit to the allowance for doubtful accounts based on historical collection trends and an assessment of the creditworthiness of current customers. The adequacy of the valuation allowance is evaluated periodically through an individual assessment of potential losses on customer accounts giving particular emphasis to accounts with invoices unpaid more than 60 days past the due date. Balances still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable. Recoveries on accounts previously written off are credited to the valuation allowance.

A lien exists on certain receivables related to fresh produce under the Perishable Agricultural Commodities Act of 1930, which partially subordinates the lien placed by the line of credit.

**(f) Inventories**

Inventories consist principally of food products and are stated at the lower of average cost (which approximates first-in, first-out) or market. Costs included in inventory consist of materials, packaging supplies, and labor. General and administrative costs are not charged to inventory.

**(g) Property and Equipment**

Property and equipment are recorded at cost. Equipment acquired under capital leases is recorded at the present value of the future minimum lease payments, and amortized on a straight-line basis over the shorter of the lease term or the estimated useful life of the asset. Expenditures for major additions and improvements are capitalized, while minor replacements, maintenance and repairs are charged to expense as incurred. When property and equipment are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in other income and expense.

Depreciation, including assets acquired under capital leases, is provided using the straight-line method over the following estimated useful lives:

| | |
|---|---|
| Plant and improvements | 15 - 40 years |
| Machinery and equipment | 5 - 15 years |
| Transportation equipment | 3 - 10 years |
| Office equipment | 5 - 7 years |

**(h) Concentrations of Credit Risk**

The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

**(i) Revenue Recognition**

The Company recognizes revenue, net of related sales discounts and allowances, when persuasive evidence of an arrangement exists (such as a customer purchase order), delivery has occurred, our price to the customer has been fixed or is determinable, and collectibility is reasonably assured. Revenues also include those amounts related to shipping and handling. Shipping and handling expenses are included in cost of sales. Consideration from the Company to a customer is presumed to be a reduction to the selling price of the Company s products and accordingly, is characterized as a reduction of sales when recognized in the Company s consolidated statements of operations. As a result, certain promotional expenses are recorded as a reduction of net sales, at the time in which the sale is recognized.

**(j) Accounting for Rebates**

The Company establishes liabilities for rebates to customers based on specific programs, expected usage and historical experience.

**(k) Income Taxes**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**(l) Earnings (Loss) Per Share**

Basic earnings (loss) per share ( EPS ) excludes dilution and is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of shares of common stock outstanding during the period. Diluted EPS is computed in a manner similar to that of basic EPS except that the weighted-average number of common shares outstanding is increased to include the number of incremental common shares (computed using the treasury stock method) that would have been outstanding if all potentially dilutive common shares (such as stock options) were issued during the period. Diluted EPS is not presented if the effect of the incremental shares is anti-dilutive. The Company has agreed to issue shares of common stock in connection with its short-term borrowing when any initial public offering is consummated. The details of this agreement are described in Note 8. The Company has not included these shares in diluted earnings per share due to the Company s net loss for the period, the effects of inclusion would be anti-dilutive.

**(m) Use of Estimates**

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. An estimate for the value of intangible assets related to customer relationships was calculated by discounting projected earnings to the date of acquisition and recognized to the extent of the contingent liability of the excess purchase price.

**(n) Fair Value of Financial Instruments**

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are measured at cost which approximates fair value because of the short-term nature of these instruments. The carrying amount of the Company s borrowings under the line of credit and long-term debt approximates fair value because the interest rate on the instruments fluctuate with market interest rates or represents borrowing rates available with similar terms.

**(o) Investments**

All of the Company s investments are classified as available for sale and reported at fair value. Any related unrealized gains and losses are excluded from earnings and reported net of income tax as a separate component of shareholders equity until realized. There were no unrealized gains or losses for the three and six months ended June 30, 2007 and 2006. Realized gains and losses on sales of securities are based on the specific identification method. Declines in the fair value of investment securities below their carrying value that are other than temporary are recognized in earnings. As of June 30, 2007 and December 31, 2006, the Company s investments consisted primarily of guaranteed investment contracts at a fixed interest rate of 2.25 percent.

**(p) Classification of Consolidated Financial Statement Items**

Certain amounts in previously reported consolidated financial statements have been reclassified to conform to the current presentation.

**(q) Recently Issued Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, and Related Implementation Issues ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a Company s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, the Company may recognize the benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the consolidated financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. FIN 48 is effective as of the beginning of fiscal years that begin after December 15, 2006. The Company is not currently subject to any specific audit by any federal, state or local taxing authority, and therefore does not expect the adoption of this interpretation to have any effect on its consolidated financial statements. The Company has taken the position that the acquisition of Allison s is a non-taxable transaction.

In September of 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, the adoption of this statement will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies an option to report selected financial assets and liabilities at fair value. SFAS No. 159 requires companies to provide information helping financial statement users to understand the effect of a company s choice to use fair value in determining its earnings, as well as to display the fair value of the assets and liabilities a company has chosen to use fair value for on the face of its balance sheet. Additionally, SFAS No. 159 establishes presentation and disclosure requirements designed to simplify comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. The Company has not determined the effects if any, the adoption of this statement will have on its consolidated financial statements.

In September 2006, the United States Securities and Exchange Commission released Staff Accounting Bulletin No.108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements , which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in

quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The adoption of SAB No. 108 did not have an effect on the Company s consolidated financial statements.

**(3) Inventories**

A summary of inventories follows:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Raw materials and supplies | $ 1,858,863 | $ 543,787 |
| Finished goods | 593,801 | 87,887 |
| Total inventory | $ 2,452,663 | $ 631,674 |

**(4) Restricted Assets**

The Company is required to hold cash in reserve in separate trust accounts applicable to its $5.0 million Cleveland County Industrial Authority Industrial Development Revenue Bonds, issued December 2004, and to secure a letter of credit for purposes of self insurance for worker s compensation. The project construction account represents proceeds of the bond offering to be drawn for approved capital expenditures. The debt reserve account represents funds to be used for debt service in the event of default. The interest and principal accounts represent deposits to be used for debt service. These assets are as follows:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Project construction account | $ 277 | $ 270 |
| Debt reserve account | 501,908 | 525,620 |
| Interest fund account | 246,420 | 71,391 |
| Principal fund account | 65,631 | 170 |
| Certificate of deposit | 250,000 | 250,000 |
| Total restricted assets | $ 1,064,236 | $ 847,451 |

**(5) Property and Equipment**

Property and equipment, at cost, consists of the following:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Land | $ 238,162 | $ 199,762 |
| Plant and improvements | 11,301,853 | 5,919,477 |
| Machinery and equipment | 7,574,523 | 4,685,688 |
| Transportation equipment | 2,034,838 | 2,096,857 |
| Office equipment | 187,158 | 78,382 |
| Construction in progress | 186,088 | 4,598,530 |
| | 21,522,622 | 17,578,696 |
| Less accumulated depreciation | (4,920,116) | (4,475,708) |
| Net Property, Plant and Equipment | $ 16,602,506 | $ 13,102,988 |

During the three months and six months ended June 30, 2007 and 2006, depreciation expense, including depreciation on assets held under capital lease obligations, was $270,416, $254,846, $516,782 and $505,883, respectively.

**(6) Assets Held for Sale**

At December 31, 2006, the Company held plant and improvements for sale with a net book value of $40,000, which it sold on June 18, 2007, for net proceeds of $18,514, representing a loss on the sale of $21,486.

**(7) Line of Credit**

At June 30, 2007 and December 31, 2006, the Company had a $4.0 million secured bank line of credit, due on October 31, 2006, providing for interest at Wall Street Journal prime rate plus 0.75 percent, with an initial rate of 6.75 percent. The line of credit was secured by accounts receivable, inventory and general intangibles.

At June 30, 2007 and December 31, 2006, short-term borrowings under the line were $2,726,578. The line of credit contains certain financial covenants which replicate those covenants of the Cleveland County Industrial Authority Bond Issue. The Company was in violation of certain covenants, as more fully defined in Note 9. The Company has not obtained a waiver of the financial covenants. In December 2006, the Company reached an informal agreement with the lender, subject to credit approval of the Company and the execution of a formal note extension agreement, to extend the line until April 30, 2007. Under the terms of the proposed extension, the maximum amount that could be borrowed under the line would be fixed at $2,726,578 and a new financial covenant would be added providing that if subsequent monthly collateral valuations are less than the value of the collateral at November 30, 2006, the borrower would immediately be deemed to be in default without any available grace period to cure such default. Further, the interest rate on borrowed funds under the line will increase from 0.75 percent over the specified prime rate to 2 percent over that prime rate and the Company would be required to pay the lender a 1 percent extension fee on borrowed funds on the execution of the extension agreement and a 2 percent extension fee on borrowed funds on the earlier of the maturity date or the completion of the Company s pending initial public offering (See Note 13). The Company repaid the line of credit on July 3, 2007 following the completion of its initial public offering. (See Note 13).

Allison s has a $1.0 million secured bank line of credit, initiated on March 3, 2006, at an interest rate of the Wall Street Journal prime rate plus 0.50 percent, with an initial rate of 8.00 percent. Interest is payable on a monthly basis. The line of credit was secured by all of Allison s assets, including accounts receivable, inventory, equipment and personal guaranties of all of the former partners. At June 30, 2007 and December 31, 2006, no amounts were outstanding pursuant to this agreement. The bank line of credit agreement was subject to certain covenants for which Allison s was in compliance as of June 30, 2007, and December 31, 2006.

Wild has a $600,000 secured bank line of credit, initiated on June 7, 2006, at an interest rate of the Wall Street Journal prime rate plus 1.00 percent. At June 30, 2007 and December 31, 2006, short-term borrowings under this line of credit were $253,995, and $0, respectively. Wild was in compliance with all covenants.

**(8) Short-term Borrowings**

The Company entered into 10 percent secured subordinated promissory notes on July 17, 2006 for a maximum of $2.0 million. The notes are secured by the pledge by certain partners of 60 percent of the limited partnership interests in Allison s. The entire principal amount of the notes and all accrued and unpaid interest thereon is due and payable on the earlier of June 30, 2007 (the Maturity Date ), or the third business day following the completion of an underwritten public offering or a private placement by the Company resulting in gross proceeds of $5 million or more (a Qualified Offering ).

The notes are subordinate to all other existing indebtedness of the Company. Borrowings under these notes were $2.0 million at June 30, 2007. As additional consideration for their purchase of notes, each purchaser of $1.5 million principal amount of notes ( First Notes ) will receive that number of equity securities to be issued in any initial public offering consummated before June 30, 2007, having a value, at the initial public offering price, of 50 percent of the notes purchased by that investor. Further, the holders of notes totaling $0.5 million which are junior to First Notes ( Junior Notes ) are to receive that number of equity securities to be issued having a value of 75 percent of the notes purchased by that investor. Proceeds of the note will be used to complete construction of the addition to the existing facility.

The liability for additional compensation of $1,125,000 is shown as Bridge funding liability on the accompanying balance sheet. In addition to the liability, an intangible asset related to the loan origination was recorded in the original amount of $1,125,000, net of amortization of $1,125,000 and $562,500 at June 30, 2007 and December 31, 2006 in the accompanying balance sheet. At June 30, 2007 and December 31, 2006, the carrying amount of this intangible asset was $562,500 and $0, respectively. The amortization of this intangible asset is recorded as interest expense in the consolidated statements of operations. The number of shares to be issued using the expected offering price of $6.50 is 173,077.

The Company repaid the notes subsequent to June 30, 2007 using a portion of the proceeds of the initial public offering.

The Company agreed to enter into a 10 percent non-secured promissory note on September 21, 2006 for a maximum of $1.0 million. The maturity date is the earlier of April 30, 2007, or the consummation of any initial public offering consummated before the maturity date. Borrowings under this note were $1.0 million at June 30, 2007. This note is payable to the underwriter that the Company was working on its initial public offering (see Note 13). Following the completion of the initial public offering, the Company entered into an agreement to extend the note to the earlier of June 30, 2008 or the closing of an equity financing in which the Company receives at least $4.0 million in gross proceeds.

**(9) Long-Term Debt and Capital Lease Obligations**

Long-term debt consists of the following:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| 6.75 - 7.10% Cleveland County Industrial Revenue Bonds secured by real property final payment due December 1, 2024 | $ 4,690,000 | $ 4,690,000 |
| 5.75 - 9.00% Real estate loans secured by real property final payments due July 22, 2009 and August 1, 2028 | 3,488,384 | 3,518,267 |
| 6.50 - 7.00% Equipment loans secured by various manufacturing equipment final payments due from 2007 thru 2008 | 9,856 | 43,552 |
| 4.75 - 6.50% Vehicle loans secured by various transportation equipment final payments due from 2008 thru 2010 | 210,421 | 299,547 |
| Consolidated entities: | | |
| 8.75% Equipment loan secured by manufacturing equipment final payment due March 3, 2011 | 1,948,268 | |
| 9.56% Equipment loans secured by refrigeration equipment final payment due May 1, 2021 | 116,971 | |
| 9.56% Real estate loan secured by real property final payment due May 1, 2021 | 146,444 | |
| 8.00 - 10.00% Equipment loans secured by aircraft final payments due November 30, 2007 and April 25, 2019 | 224,844 | 242,586 |
| Total long-term debt | 10,835,188 | 8,793,952 |
| Less current portion | 932,745 | 606,885 |
| Net long-term debt | $ 9,902,443 | $ 8,187,067 |

The Industrial Development Revenue Bonds issued by Cleveland County Industrial Authority contain certain financial covenants as follows:

**Debt Service Coverage Ratio**: The Company is required to maintain a debt service coverage ratio of 1.50 to 1.00. The ratio will be reported to the Trustee and notice given to Beneficial Owners quarterly for each of the previous four quarters. If the Debt Service coverage ratio reported for each of the previous four quarters is less than 1.50 to 1.00 the Company is required to retain a consultant. For the three months ended June 30, 2007, the Company s Debt Service Coverage ratio is 1.03 to 1.00. The trustee has not required the Company to retain a consultant.

**Current Ratio:** The Company is required to maintain a current ratio 1.10 to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. As of June 30, 2007, the Company s current ratio is 0.40 to 1.00.

**Debt to Equity Ratio:** The Company is required to maintain a debt to equity ratio of not more than 4.00 to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. As of June 30, 2007, the Company s debt to equity ratio could not be calculated due to a negative equity balance.

**Accounts Payable:** The Company agrees that not more than 20 percent of its accounts payable shall be in excess of 90 days past due. The Company is in compliance with this covenant as of June 30, 2007.

**Accounts Receivable:** The Company agrees that not more than 20 percent of accounts receivable will be in excess of 90 days past due. The Company is in compliance with this covenant as of June 30, 2007. Noncompliance with the debt service coverage ratio, the current ratio, or the debt to equity ratio will not be considered an event of default under the terms of the agreement. Noncompliance with the above ratios has resulted in an increase in the interest rate on each of the Bonds of 1 percent until the Company is in compliance with the required ratios.

Capital lease obligations consist of the following:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| 8.95 - 9.19% Equipment leases | $ 569,043 | $ 651,988 |
| 8.62% Equipment lease | 5,877 | |
| | 574,920 | 651,988 |
| Less current portion | (181,052) | (172,370) |
| Capital lease obligations, net of current portion | $ 393,868 | $ 479,618 |

**Annual Debt Service Requirements**

The annual principal payment requirements to maturity, for long-term debt and capital lease obligations at June 30, 2007 are as follows:

| Year Ending June 30, | Long-Term Debt | Capital Lease Obligations | Total |
|---|---|---|---|
| 2008 | $ 932,745 | $ 181,052 | $ 1,113,797 |
| 2009 | 844,622 | 196,344 | 1,040,966 |
| 2010 | 1,069,326 | 186,445 | 1,255,771 |
| 2011 | 723,228 | 11,079 | 734,307 |
| 2012 | 1,833,141 | | 1,833,141 |
| Thereafter | 5,432,126 | | 5,432,126 |
| Principal outstanding at June 30, 2007 | $ 10,835,188 | $ 574,920 | $ 11,410,108 |

During the three months and six months ended June 30, 2007 and 2006, total interest costs were $777,932, $253,333, $1,396,967 and $516,387, respectively. The amount of interest costs capitalized to construction projects during the six months ended June 30, 2007 was $106,988.

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**(10) Accrued Liabilities**

A summary of accrued liabilities follows:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Rebates | $ 776,393 | $ 403,071 |
| Interest expense | 473,324 | 156,420 |
| Compensation | 389,569 | 179,379 |
| Workers compensation | 279,479 | 158,976 |
| Payroll taxes | 106,907 | 40,515 |
| Promotions and incentives | 89,725 | 41,102 |
| Property taxes | 51,549 | 32,522 |
| Other | 7,351 | |
| Total accrued liabilities | $ 2,174,297 | $ 1,011,985 |

**(11) Amounts Payable to Former Owners of Wild**

Allison s has current liabilities in the amount of $500,000 and long-term liabilities in the amount of $126,780 which are related to contingent payments to former owners of Wild.

**(12) Intangible Assets**

Allison s holds an intangible asset, a customer list related to its acquisition by the Company in the amount of $154,210. The Company will begin amortizing the asset to expense over a period of five years beginning July 1, 2007. Allison s holds an intangible asset, a customer relationship with a certain customer of Wild. The value of the customer relationship is $700,333 net of amortization of $76,863 at June 30, 2007. The Company amortizes the asset to expense over a period of five years. The amount of annual amortization expense related to the June 30, 2007 value of the customer relationship is $172,000. The earnings of Wild will cause an increase in the value, which will add additional amortization expense.

**(13) Initial Public Offering**

Subsequent to June 30, 2007, the Company completed an initial public offering of its shares. The offering consisted of 2.15 million units, with each unit consisting of one share of common stock, one Class A warrant and one Class B warrant. The units were priced at $6.50 each in the offering.

Class A warrants entitle the holder to buy one common share at $9.75 a share. The Class B warrants entitle holders to buy one share at $13 a share.

Each Class A warrant entitles its holder to purchase one share of common stock at an exercise price equal to 150 percent of the initial unit offering price.

Each Class B warrant entitles its holder to purchase one share of common stock at an exercise price equal to 200 percent of the initial unit offering price.

The Class A and Class B warrants are exercisable at any time after they become separately tradable. The Company may redeem some or all of the warrants commencing six months after this offering, after they become separately tradeable, at a price of $0.25 per warrant, on 30 days notice to the holders. On July 27, 2007, the units separated into common stock and warrant and the stock and each warrant commenced trading,

individually, on that date, on the NASDAQ Capital Market under the symbols: FOOD for the common stock, FOODW for the Class A warrants and FOODZ for the Class B warrants. The Units will cease to trade on that date.

The Company may redeem the Class B warrants only if its gross revenue, for any period of twelve months preceding the notice is equal to or greater than $100 million.

The Class A and Class B warrants expire on June 27, 2012.

A portion of the proceeds from the offering were used to (a) acquire the partnership interests in Allison s for $1.5 million in cash and a deferred payment of $1.0 million (see Note 19), (b) repay a short-term borrowing of $2.0 million which has been used to complete the extension of our existing facility, and (c) repay our bank line of credit of $2.7 million. The remainder of the proceeds are expected to be used to construct or acquire one or more new facilities and to supplement our working capital for general corporate purposes.

**(14) Income Taxes**

Income tax expense (benefit) for the three months and six months ended June 30, 2007 and 2006, consist of the following:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (unaudited) | | (unaudited) | |
| **Current:** | | | | |
| Federal | $ | $ | $ | $ |
| State | | | | |
| | | | | |
| **Deferred:** | | | | |
| Federal | (87,352) | (435,407) | 48,417 | (222,599) |
| State | (10,281) | (51,244) | 5,698 | (26,198) |
| | (97,633) | (486,651) | 54,115 | (248,797) |
| Total income tax expense (benefit) | $ (97,633) | $ (486,651) | $ 54,115 | $ (248,797) |

Deferred tax assets (liabilities) are as follows:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Net operating loss carryforward | $ 554,265 | $ 613,749 |
| Oklahoma Job and Investment Credits | 99,737 | 99,737 |
| Depreciation | (529,035) | (535,394) |
| Other | 47,754 | 48,744 |
| Net deferred tax asset | $ 172,721 | $ 226,836 |
| Current portion | $ 23,727 | $ 24,717 |
| Non-current portion | 148,994 | 202,119 |
| | $ 172,721 | $ 226,836 |

In assessing the realizability of the net deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon either the generation of future taxable income during the periods in which those temporary differences become deductible or the carryback of losses to recover income taxes previously paid during the carryback period.

The Company is not currently subject to any specific audit by any federal, state or local taxing authority. There are no unrecognized tax benefits or tax positions previously taken which could give rise to uncertainty, and therefore there are no calculations or classifications of interest, penalties or effects on income tax rates related to such uncertainties. The Company has taken the position that the acquisition of Allison s is a non-taxable transaction.

As of June 30, 2007, the Company has a net operating loss carryforward of $1,458,591 which, if unused, will commence expiring in 2018 and state new jobs/investment credit carryforwards totaling $99,737 of which, if unused, $12,170 will expire on December 31, 2007.

Actual income tax expenses differ from expected income tax, computed by applying the U.S. Federal corporate tax rate of 34 percent to earnings from operations before income taxes, as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2007 (unaudited) | 2006 (unaudited) | 2007 (unaudited) | 2006 (unaudited) |
| Computed expected income taxes | $ (184,962) | $ (403,743) | $ (171,231) | $ (237,047) |
| State income taxes, net of federal income tax | (32,640) | (71,249) | (30,217) | (41,832) |
| Permanent difference due to amortization of equity transactions | 95,625 | | 191,250 | |
| Utilization of net operating loss carryforwards against current income and other, net | 24,344 | (11,659) | 64,313 | 30,082 |
| | $ (97,633) | $ (486,651) | $ 54,115 | $ (248,797) |

**(15) Operating Leases**

The Company has noncancelable long-term operating leases for certain distribution equipment with various expiration dates and one lease for refrigerated warehouse space. The equipment leases require the Company to pay a base rate plus specific mileage amounts. Future minimum annual lease payments for these long-term leases for the next five years ending June 30,

| | | (unaudited) |
|---|---|---|
| 2008 | $ | 332,758 |
| 2009 | | 232,930 |
| 2010 | | 87,747 |
| 2011 | | 44,828 |
| 2012 | | |
| | $ | 698,263 |

**(16) Employee Benefit Plans**

In 2002, the Company adopted a Flexible 401(k) plan covering all full-time employees with a minimum of one year of service. The Company makes contributions under the plan at an amount equal to 25 percent of the employee s elective deferral rate, up to a maximum of 4 percent of the employee s compensation. The Company s contributions to the plan during the three months and six months ended June 30, 2007 and 2006 were $2,560, $2,105, $4,441 and $3,269, respectively.

In August 2006, the Company adopted a stock option plan providing for potential awards of up to 1,000,000 shares. No shares or options have been issued under the plan.

**(17) Major Customers**

The Company has supply arrangements with a certain retailer, representing about 8 percent of its customer sales, and supply arrangements with a certain distributor which account for approximately 22 percent of gross revenues. While such purchasers are each independent, it is possible that a termination of a purchasing arrangement with any such entity could adversely affect business relationships with related entities.

Allison s has two customers that represent 30 percent and 27 percent of Allison s sales, respectively. A change in one of these customer relationships could adversely affect the Company s financial position, results of operations or cash flows.

On a pro-forma basis, taking into account the acquisition of Allison s on June 30, 2007, the supply agreements with the certain retailer and distributor represent 5.3 percent and 14.3 percent of consolidated proforma revenues, respectively, for the three months ended June 30, 2007. The two significant Allison s customers represent 10.6 percent and 9.5 percent, respectively of those proforma consolidated revenues.

**(18) Related Party Transactions**

On March 1, 2003, the two stockholders of the Company became limited partners in Allison s. During the normal course of business, the Company sells raw materials and finished goods, provides freight services to Allison s and purchases finished goods for resale to its customers.

The Company provides a discounted price for products sold to Allison s for use as ingredients in Allison s products. All other transactions between the companies are at fair market value.

On June 30, 2007, Allison s merged into the Company.

During the three months and six months ended June 30, 2007 and 2006, the Company s sales, including freight services, to Allison s and purchases from Allison s were as follows (unaudited):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Sales of product to Allison s | $ 299,774 | $ 266,423 | $ 491,739 | $ 440,260 |
| Freight revenue from Allison s | 119,191 | 185,714 | 207,634 | 310,496 |
| Purchases from Allison s | 136,624 | 185,271 | 285,403 | 280,414 |

The Company leases a portion of its facilities to Allison s on an annual lease agreement. The lease agreement provides for nine consecutive one year options to extend the lease agreement. The Company and Allison s share utilities, sales and administration staff, and other facility expenses. Allison s reimburses the Company for its portion of the shared expenses through periodic reimbursement. A summary of the shared expenses for the three months and six months ended June 30, 2007 and 2006 are as follows (unaudited):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Rents | $ 124,624 | $ 83,850 | $ 219,805 | $ 166,425 |
| Utilities | 34,127 | 55,223 | 79,220 | 93,871 |
| Salaries | 40,369 | 59,248 | 86,812 | 109,215 |

At June 30, 2007 and December 31, 2006 amounts due from Allison s were $354,328 and $144,243, respectively. Accounts payable related to purchases from Allison s were $36,799 and $69,502 at June 30, 2007 and December 31, 2006, respectively. The amounts are eliminated on the June 30, 2007 consolidated balance sheet.

**(19) Commitments and Contingencies**

The Company and its subsidiaries are subject to legal proceedings and claims which arise in the ordinary course of business. Although occasional adverse decisions or settlements may occur, the Company is not aware of any proceeding at June 30, 2007, which would have a material adverse effect on its consolidated financial position, results of operations or liquidity.

**(20) Cimarron Holdings, L.L.C.**

The Company s two shareholders (prior to the initial public offering) each had a 50 percent ownership in Cimarron Holdings, LLC. ( Cimarron ). Cimarron owns an airplane that is used by Company management. The Company has not guaranteed the obligations of Cimarron, but is making the debt service payments for Cimarron, as well as all of the costs of maintenance and operations of the airplane.

The Company s consolidated financial statements include the financial statements of Cimarron. The consolidation of Cimarron increased the Company s consolidated total assets and liabilities at June 30, 2007 and December 31, 2006 as follows:

| | June 30, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| Total assets | $ 196,096 | $ 219,665 |
| Total liabilities | 224,844 | 242,586 |

**(21) Acquisition of Wild**

Effective June 1, 2006, Allison s acquired certain assets and assumed certain liabilities of Wild and All For One, Inc. (together, Wild ). Wild produces refrigerated food products for food service and retail customers. The purchase price was comprised of a cash payment of $7,000, Notes payable to the sellers totaling $250,000, assumption of (i) a mortgage loan of $154,000, (ii) a line of credit loan of $23,000, (iii) a capital lease of $9,000, and (iv) accounts payable and other liabilities of $236,000.

Assets acquired amounted to cash and accounts receivable of $25,000, inventory of $131,000 and property and equipment of $523,000. In addition, the acquisition provides for a contingent payment equal to 65 percent of operating income over and above $250,000, as defined, during the three-year period following the closing.

Customer relationships have been recorded as identifiable intangible assets in connection with the acquisition of Wild, and are being amortized to expense over a five year period commencing with the first period of capitalization and increasing as the capitalization of the intangible asset increases.

The following is a summary of the amounts capitalized and amortized to expense since the inception of the agreement to acquire Wild:

| | From Acquisition Through December 31, 2006 | During the Six Months Ended June 30, 2007 | Cumulative as of June 30, 2007 |
|---|---|---|---|
| | | (unaudited) | |
| Contingent purchase price costs capitalized | $ 220,605 | $ 556,591 | $ 777,196 |
| Less: amortization of intangible assets | (7,920) | (68,943) | (76,863) |
| Net book value | $ 212,685 | $ 487,648 | $ 700,333 |

**(22) Acquisition of Allison s**

On June 30, 2007, we acquired (i) for nominal consideration, 60 percent of the limited partnership interests in Allison s from Mark Vaughan, our President and Chief Operating Officer, and Vernon J. Brandt, our Vice President Operations, (ii) the general partnership interest in Allison s from Braxton Management, Inc., in return for our agreement to indemnify it from all liability as the former general partner of Allison s, and (iii) for a total price of $2,500,000, the remaining 40 percent of the limited partnership interests in Allison s from Herbert Grimes, our Chairman and Chief Executive Officer and Stan Gustas, our Chief Financial Officer.

We consummated these acquisitions pursuant to agreements dated April 20, 2007, as contemplated by the Prospectus for our initial public offering. Allison s was acquired to increase our productive capacity for refrigerated prepared salads, increase our utilization of refrigerated delivery capacity and broaden our product line.

The purchase price for these 40 percent minority interests in Allison s was $2.5 million. Of the total purchase price minority interests, $1.5 million was paid from the net proceeds of our initial public offering, which closed on July 3, 2007.

Mr. Grimes, through Braxton Management, Inc., owned 87.5 percent of such minority limited partnership interests and received $1,312,500 of such net proceeds. Mr. Gustas owned the remaining 12.5 percent of such minority limited partnership interests and received $187,500 of such net proceeds. The $1.0 million balance of the purchase price for the 40 percent minority interests, which bears interest at 10 percent per annum, will

be paid, $875,000 to Mr. Grimes and $125,000 to Mr. Gustas, upon the earlier of June 30, 2008, or the closing of an equity financing in which we raise at least $4.0 million in gross proceeds.

The terms of the acquisition of the limited partnership interests in Allison s were approved by our board of directors at the time we entered into the acquisition agreements. At that time, we lacked sufficient independent directors for majority approval by independent directors. The terms of the acquisition of the limited partnership interests in Allison s were at least as favorable to us as could have been obtained through arms length negotiations with unaffiliated third parties.

The acquisition of Allison s was accounted for as a purchase and, accordingly, all assets and liabilities have been stated at their fair values at the date of the acquisition and are included in the accompanying consolidated balance sheet as of June 30, 2007.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. Allison s is in the process of further evaluating the fair values of its assets and liabilities and, accordingly, the following allocation may be subject to further adjustment:

| | | |
|---|---|---|
| Current assets | $ | 4,418,036 |
| Property and equipment | | 3,354,543 |
| Intangible assets | | 872,569 |
| Total assets acquired | | 8,645,148 |
| Current liabilities | | (3,307,786) |
| Accounts payable - related party | | (354,328) |
| Long term liabilities | | (1,856,254) |
| Amounts payable to former owners of Wild | | (626,780) |
| Total liabilities assumed | | (6,145,148) |
| Net assets acquired | $ | 2,500,000 |

Of the $872,569 of intangible assets, substantially all of the amount represents customer relationships, which are being amortized over a five-year period.

The following table summarizes the statements of operations of Allison s for the three month and six month periods ended June 30, 2007 and 2006, respectively:

| | Three Months ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (unaudited) | | | |
| Net sales | $ 7,523,309 | $ 4,961,438 | $ 13,232,939 | $ 8,234,671 |
| Gross profit | 1,254,024 | 857,333 | 2,390,135 | 1,339,621 |
| Selling general and administrative expenses | 794,564 | 524,261 | 1,462,715 | 933,363 |
| Operating income | 459,460 | 333,072 | 927,420 | 406,258 |
| Interest expense | 57,557 | 30,264 | 75,948 | 34,953 |
| Net income | 401,903 | 302,808 | 851,472 | 371,305 |

The results of operations for Allison s have not been included in the primary financial statement for the three month and six month periods ended June 30, 2007, since the transaction was consummated as of the close of business on June 30, 2007. The following Unaudited Proforma Condensed Consolidated Statements of Operations for the three months and six months ended June 30, 2007 and 2006 give effect to the acquisition of Allison s and the completion of the initial public offering as if they had occurred on or before January 1, 2006:

**Vaughan Foods, Inc. and Allison s Gourmet Kitchens, LP**
**Unaudited Proforma Condensed Consolidated Statements of Operations**

**Three Months Ended June 30, 2007**

| | Vaughan Historical | Acquisition of Allison | | ProForma Post Acquisition | IPO Adjustments | | ProForma Post IPO |
|---|---|---|---|---|---|---|---|
| | (unaudited) | (unaudited) | | (unaudited) | | | (unaudited) |
| Net sales | $ 13,945,725 | $ 6,967,720 | A1 | $ 20,913,445 | | | $ 20,913,445 |
| Cost of sales | 12,858,724 | 5,589,072 | A2 | 18,447,796 | | | 18,447,796 |
| Gross profit | 1,087,001 | 1,378,648 | | 2,465,649 | | | 2,465,649 |
| Selling, general and administrative expenses | 969,755 | 802,275 | A3 | 1,772,030 | | | 1,772,030 |
| Operating income | 117,246 | 576,374 | | 693,620 | | | 693,620 |
| Rent income | 124,624 | (124,624) | A4 | | | | |
| Interest expense | (777,932) | (82,557) | A5 | (860,489) | 602,074 | A7 | (258,415) |
| Loss on sale of asset | (21,486) | | | (21,486) | | | (21,486) |
| Interest and other income | 13,543 | | | 13,543 | | | 13,543 |
| Other income and expense, net | (661,251) | (207,181) | | (868,432) | 602,074 | | (266,358) |
| (Loss) before income taxes | (544,005) | 369,193 | | (174,813) | 602,074 | | 427,262 |
| Income tax expense (benefit) | (97,633) | 152,723 | A6 | 55,090 | 107,269 | A8 | 162,359 |
| Net earnings (loss) | $ (446,372) | $ 216,470 | | (229,903) | 494,805 | | $ 264,903 |
| Weighted average shares outstanding - basic and diluted | 2,300,000 | | | 2,300,000 | 2,150,000 | A9 | 4,450,000 |
| Net income (loss) per share - basic and diluted | $ (0.19) | | | $ (0.10) | | | $ 0.06 |

**Notes to Unaudited Proforma Condensed Consolidated Statements of Operations Three Months Ended June 30, 2007**

A1 Allison s historical sales of $7,523,309, less intercompany elimination of sales between Vaughan and Allison in the amount of $555,589.

A2

Allison s historical cost of sales of $6,269,285, less intercompany elimination of sales between Vaughan and Allison, plus the rent paid by Allison s to Vaughan in the amount of $555,589 and $124,624, respectively.

A3 Allison s historical selling, general and administrative expenses plus amortization of the customer list value of $7,711 (calculated by dividing the $154,210 acquisition

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valuation of customer list at the balance sheet date of June 30, 2007, amortized over 5 years).

A4 Elimination of intercompany rent income of $124,624 paid by Allison s to Vaughan.

A5 Allison s interest expense plus proforma adjustment to reflect the interest expense at 10 percent on the deferred portion of purchase price of Allison s in the amount of $1,000,000.

A6 Income tax provision adjustment on Allison s earnings at an assumed effective rate of 38 percent.

A7 Proforma adjustment to remove amortization of bridge note asset, amortization of loan originations and reduce interest expense related to debt instruments retired with IPO proceeds, including the bank line of credit and bridge notes.

A8 Proforma adjustment to record tax provision on pretax income using an assumed effective rate of 38 percent.

A9 Proforma adjustment to reflect issuance of 2,150,000 common shares in connection with the IPO.

**Vaughan Foods, Inc. and Allison s Gourmet Kitchens, LP**
**Unaudited Proforma Condensed Consolidated Statements of Operations**

| | Three Months Ended June 30, 2006 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Vaughan Historical | Acquisition of Allison | | ProForma Post Acquisition | IPO Adjustments | | ProForma Post IPO |
| | (unaudited) | (unaudited) | | (unaudited) | | | (unaudited) |
| Net sales | $ 13,820,293 | $ 4,324,030 | B1 | $ 18,144,323 | | | $ 18,144,323 |
| Cost of sales | 13,677,419 | 3,382,847 | B2 | 17,060,266 | | | 17,060,266 |
| Gross profit | 142,874 | 941,183 | | 1,084,057 | | | 1,084,057 |
| Selling, general and administrative expenses | 1,177,009 | 531,972 | B3 | 1,708,981 | | | 1,708,981 |
| Operating income | (1,034,135) | 409,212 | | (624,924) | | | (624,924) |
| Rent income | 83,850 | (83,850) | B4 | | | | |
| Interest expense | (253,333) | (55,264) | B5 | (308,597) | 63,920 | B7 | (244,677) |
| Loss on sale of asset | | | | | | | |
| Interest and other income | 16,139 | | | 16,139 | | | 16,139 |
| Other income and expense, net | (153,344) | (139,114) | | (292,458) | 63,920 | | (228,538) |
| (Loss) before income taxes | (1,187,479) | 270,098 | | (917,382) | 63,920 | | (853,462) |
| Income tax expense (benefit) | (486,651) | 115,067 | B6 | (371,584) | 47,269 | B8 | (324,315) |
| Net earnings (loss) | $ (700,828) | $ 155,030 | | (545,798) | 16,651 | | $ (529,147) |
| Weighted average shares outstanding - basic and diluted | 2,300,000 | | | 2,300,000 | 2,150,000 | B9 | 4,450,000 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Net income (loss) per share - basic and diluted | $ (0.30) | | $ (0.24) | | $ (0.12) |

**Notes to Unaudited Proforma Condensed Consolidated Statements of Operations Three Months Ended June 30, 2006**

B1 Allison s historical sales of $4,961,438, less intercompany elimination of sales between Vaughan and Allison in the amount of $637,408.

B2 Allison s historical cost of sales of $4,104,105, less intercompany elimination of sales between Vaughan and Allison, plus the rent paid by Allison to Vaughan in the

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amount of $637,408 and $83,850, respectively.

B3 Allison s historical selling, general and administrative expenses plus amortization of the customer list value of $7,711 (calculated by dividing the $154,210 acquisition valuation of customer list at the balance sheet date of June 30, 2007, amortized over 5 years).

B4 Elimination of intercompany rent income of $83,850 paid by Allison to Vaughan.

B5 Allison s interest expense plus proforma adjustment to reflect the interest expense at 10 percent on the deferred portion of purchase price of Allison s in the amount of $1,000,000.

B6 Income tax provision adjustment on Allison s earnings at an assumed effective rate of 38 percent.

B7 Proforma adjustment to remove amortization of bridge note asset, amortization of loan originations and reduce interest expense related to debt instruments retired with a portion of the IPO proceeds, including the bank line of credit and bridge notes.

B8 Proforma adjustment to record tax provision on pretax income using an assumed effective rate of 38 percent.

B9 Proforma adjustment to reflect issuance of 2,150,000 common shares in connection with the IPO.

**Vaughan Foods, Inc. and Allison s Gourmet Kitchens, LP**
**Unaudited Proforma Condensed Consolidated Statements of Operations**

| | Six Months Ended June 30, 2007 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Vaughan Historical | Acquisition of Allison | | ProForma Post Acquisition | IPO Adjustments | | ProForma Post IPO |
| | (unaudited) | (unaudited) | | (unaudited) | | | (unaudited) |
| Net sales | $ 26,478,941 | $ 12,248,163 | C1 | $ 38,727,104 | | | $ 38,727,104 |
| Cost of sales | 24,005,232 | 9,638,223 | C2 | 33,643,455 | | | 33,643,455 |
| Gross profit | 2,473,709 | 2,609,940 | | 5,083,649 | | | 5,083,649 |
| Selling, general and administrative expenses | 1,803,200 | 1,478,136 | C3 | 3,281,336 | | | 3,281,336 |
| Operating income | 670,509 | 1,131,804 | | 1,802,313 | | | 1,802,313 |
| Rent income | 219,805 | (219,805) | C4 | | | | |
| Interest expense | (1,396,967) | (125,948) | C5 | (1,522,915) | 1,020,244 | C7 | (502,671) |
| Loss on sale of asset | (21,486) | | | (21,486) | | | (21,486) |
| Interest and other income | 24,518 | | | 24,518 | | | 24,518 |
| Other income and expense, net | (1,174,130) | (345,753) | | (1,519,883) | 1,020,244 | | (499,639) |
| (Loss) before income taxes | (503,621) | 786,051 | | 282,430 | 1,020,244 | | 1,302,674 |
| Income tax expense (benefit) | 54,115 | 323,559 | C6 | 377,674 | 117,343 | C8 | 495,017 |
| Net earnings (loss) | $ (557,736) | $ 462,492 | | (95,244) | 902,901 | | $ 807,657 |

| | | | | | |
|---|---|---|---|---|---|
| Weighted average shares outstanding - basic and diluted | 2,300,000 | | 2,300,000 | 2,150,000 C9 | 4,450,000 |
| Net income (loss) per share - basic and diluted | $ (0.24) | | $ (0.04) | | $ 0.18 |

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**Unaudited Proforma Condensed Consolidated Statements of Operations Six Months Ended June 30, 2007**

C1 Allison s historical sales of $13,232,939, less intercompany elimination of sales between Vaughan and Allison in the amount of $984,776.

C2 Allison s historical cost of sales of $10,842,804, less intercompany elimination of sales between Vaughan and Allison, plus the rent paid by Allison to Vaughan in the amount of $984,776 and $219,805, respectively.

C3 Allison s historical selling, general and administrative expenses plus amortization of the customer list value of $15,421 (calculated by dividing the $154,210 acquisition valuation of customer list at the balance sheet date of June 30, 2007, amortized over 5 years).

C4 Elimination of intercompany rent income of $219,805 paid by Allison to Vaughan.

C5 Allison s interest expense plus proforma adjustment to reflect the interest expense at 10 percent on the deferred portion of purchase price of Allison s in the amount of $1.0 million.

C6 Income tax provision adjustment on Allison s earnings at an assumed effective rate of 38 percent.

C7 Proforma adjustment to remove amortization of bridge note asset, amortization of loan originations and reduce interest expense related to debt instruments retired with a portion of the IPO proceeds, including the bank line of credit and bridge notes.

C8 Proforma adjustment to record tax provision on pretax income using an assumed effective rate of 38 percent.

C9 Proforma adjustment to reflect issuance of 2,150,000 common shares in connection with the IPO.

**Vaughan Foods, Inc. and Allison s Gourmet Kitchens, LP**
**Unaudited Proforma Condensed Consolidated Statements of Operations**

| | Six Months Ended June 30, 2006 | | | | |
|---|---|---|---|---|---|
| | Vaughan Historical | Acquisition of Allison | ProForma Post Acquisition | IPO Adjustments | ProForma Post IPO |
| | (unaudited) | (unaudited) | (unaudited) | | (unaudited) |
| Net sales | $ 26,317,960 | $ 7,203,501 D1 | $ 33,521,461 | | $ 33,521,461 |
| Cost of sales | 24,486,599 | 5,697,455 D2 | 30,184,054 | | 30,184,054 |
| Gross profit | 1,831,361 | 1,506,046 | 3,337,407 | | 3,337,407 |
| Selling, general and administrative expenses | 2,206,912 | 948,784 D3 | 3,155,696 | | 3,155,696 |
| Operating income | (375,551) | 557,262 | 181,711 | | 181,711 |
| Rent income | 166,425 | (166,425) D4 | | | |
| Interest expense | (516,387) | (84,953) D5 | (601,340) | 114,429 D7 | (486,911) |
| Loss on sale of asset | | | | | |
| Interest and other income | 28,314 | | 28,314 | | 28,314 |
| Other income and expense, net | (321,648) | (251,378) | (573,026) | 114,429 | (458,597) |
| (Loss) before income taxes | (697,199) | 305,884 | (391,315) | 114,429 | (276,886) |
| Income tax expense (benefit) | (248,797) | 141,096 D6 | (107,701) | 2,484 D8 | (105,217) |
| Net earnings (loss) | $ (448,402) | $ 164,788 | (283,614) | 111,945 | $ (171,669) |
| Weighted average shares outstanding - basic and diluted | 2,300,000 | | 2,300,000 | 2,150,000 D9 | 4,450,000 |
| Net income (loss) per share - basic and diluted | $ (0.19) | | $ (0.12) | | $ (0.04) |

**Unaudited Proforma Condensed Consolidated Statements of Operations Six Months Ended June 30, 2006**

D1 Allison s historical sales of $8,234,671, less intercompany elimination of sales between Vaughan and Allison s in the amount of $1,031,170.

D2 Allison s historical cost of sales of $6,895,050, less intercompany elimination of sales between Vaughan and Allison, plus the rent paid by Allison s to Vaughan in the amount of $1,031,170 and $166,425, respectively.

D3 Allison s historical selling, general and administrative expenses plus amortization of the customer list value of $15,421 (calculated by dividing the $154,210 acquisition valuation of customer list at the balance sheet date of June 30, 2007, amortized over 5 years).

D4 Elimination of intercompany rent income of $166,425 paid by Allison s to Vaughan.

D5 Allison s interest expense plus proforma adjustment to reflect the interest expense at 10 percent on the deferred portion of purchase price of Allison s in the amount of $1.0 million.

D6 Income tax provision adjustment on Allison s earnings at an assumed effective rate of 38 percent.

D7 Proforma adjustment to remove amortization of bridge note asset, amortization of loan originations and reduce interest expense related to debt instruments retired with a portion of the IPO proceeds, including the bank line of credit and bridge notes.

D8 Proforma adjustment to record tax provision on pretax income using an assumed effective rate of 38 percent.

D9 Proforma adjustment to reflect issuance of 2,150,000 common shares in connection with the IPO.

**ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATONS.**

**Forward-looking Statements**

Certain written and oral statements set forth below or made by the Company with the approval of an authorized executive officer constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words believe, expect, intend, anticipate, project, will and similar expressions identify forward-looking statements, which convey the uncertainty of future events and generally are not historical in nature. All statements which address operating performance, events or developments that we expect or anticipate will occur in the future, including statements relating to the business, expansion and marketing strategies of the Company, industry projections or forecasts, the impact on our financial statements of inflation, legal action, future debt levels, sufficiency of cash flow from operations and borrowings and statements expressing general optimism about future operating results, are forward-looking statements. Such statements are based upon our management s current estimates, assumptions and expectations, which are based on information available at the time of the disclosure, and are subject to a number of factors and uncertainties, including, but not limited to:

- whether our assumptions turn out to be correct;
- our ability to attain such estimates and expectations;
- our ability to execute our strategy;
- a downturn in market conditions in any industry, including the economic state of the food industry;
- the effects of, or changes in, economic and political conditions in the U.S. and the markets in which we serve;
- our ability to reasonably forecast prices of the commodities we purchase;
- our ability to timely forecast and meet customer demand for fresh-cut salads and refrigerated prepared salads;
- our ability to respond to changing consumer spending patterns; and
- our ability to attract and retain quality employees and control our labor costs.

Any of the foregoing factors and uncertainties, as well as others, could cause actual results to differ materially from those described herein. We undertake no obligation to affirm, publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with the unaudited consolidated financial statements of the Company and the related notes thereto appearing elsewhere in this report.

**General**

We process and package value-added, refrigerated foods which we distribute to our customers three or more times per week in our fleet of refrigerated trucks and trailers. Distribution is concentrated in the 12-state marketing area within a 500 mile radius of our plant in Moore, Oklahoma, a suburb of Oklahoma City, consisting of all or portions of the states of Arkansas, Colorado, Iowa, Kansas, Louisiana, Mississippi, Missouri, Nebraska, Oklahoma, New Mexico, Tennessee and Texas. Our marketing area is largely determined by the short shelf life of our products and, to a lesser extent, by the cost of refrigerated shipping.

Our principal products fall into two categories: refrigerated prepared salads, such as chicken, tuna, bean and pasta salads, coleslaw and potato salad, and fresh-cut produce, primarily salads and salad mixes. Refrigerated prepared salads generate higher gross profit margins than our fresh-cut produce.

We produce approximately 70 different salad products in a variety of food service and retail package sizes, including custom vegetable mixes and custom sized packages for our large volume customers. Salads and salad mixes are sold primarily to restaurant chains, food service businesses, institutional users and, to a lesser extent, retail chains while the bulk of our refrigerated prepared salads are sold to grocery store deli departments, food service distributors and regional restaurant chains.

**Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that effect the amounts reported in the Company s consolidated financial statements and accompanying notes. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. The amounts of assets and liabilities reported in our balance sheets and the amounts of revenues and expenses reported for each of our fiscal periods are affected by the critical estimates and assumptions which are used for, but not limited to, the accounting for inventory, rebates, impairment of long-lived assets, and allowance for doubtful accounts. Actual results could differ from these estimates.

*Inventory*: Inventory purchases and purchase commitments are based upon forecasts of demand. Our inventory is stated at the lower of average cost (which approximates first-in, first-out) or market. Inventory turns rapidly due to the nature of our fresh products and, accordingly, market valuation is not a major challenge. If we believe that demand no longer allows us to sell certain inventory above cost or at all, then we revalue that particular inventory to market or charge-off excess inventory levels. If customer demand subsequently differs from our forecasts, requirements for inventory revaluations and charge-offs could differ from our estimates. We have not experienced material inventory revaluations or charge-offs in the past and manage inventory levels of both perishable and nonperishable supplies to minimize the effects of any revaluations.

*Allowance for Doubtful Accounts:* The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and an assessment of international, political and economic risk as well as the aging of the accounts receivable. If there is a change in a customer s creditworthiness or actual defaults differ from our historical experience, our estimates of recoverability of amounts due us will be affected. We continually monitor customer accounts for indications of a customer s inability to pay. Overdue accounts get special attention. Our recent losses on charged-off accounts have not been material.

*Long-lived Assets:* Long-lived assets such as property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not ultimately be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its ultimate disposition. Cash flow estimates used in evaluating for impairment represent management s best estimates using appropriate assumptions and projections at the time. We have not experienced any write downs due to impairment for equipment in use. The depreciation lives of these assets are short (5 - 7 years), resulting in relatively low net book values. Equipment not in use is depreciated in full or held for sale at its estimated recovery value.

*Intangible Assets:* We evaluate the recoverability of intangible assets annually or more frequently if impairment indicators arise. Under SFAS No. 144, Accounting for the Impairment and Disposal of Long-Lived Assets, intangible assets are evaluated whenever events or changes in circumstances indicate that the carrying value exceeds its fair value, which is determined based upon the estimated undiscounted future cash flows expected to result from the use of the asset, including disposition. Cash flow estimates used in evaluating for impairment represent management s best estimates using appropriate assumptions and projections at the time. We believe that accounting

for intangible assets is a critical accounting policy due to the requirement to estimate the value in accordance with SFAS No. 144. Our intangible assets consist primarily of customer relationship intangibles of purchased entities.

**Comparison of Three Months Ended June 30, 2007 and 2006**

We recorded a net loss for the second quarter of 2007 of $446,000, or $0.19 per share, compared with a net loss of $701,000 or $0.30 per share during the second quarter of 2006. Our operating results for the second quarter were adversely affected by a provision of $200,000 in connection with a settlement with a supplier and by higher interest costs than in the corresponding quarter of the previous year. Operating results were positively affected by higher gross margin amounts and percentages, as a result of higher average selling prices per pound, and by reducing or terminating our relationships with unprofitable customers.

*Net sales.* Net sales increased by $125,000, or 0.9 percent in the second quarter of 2007, compared to the second quarter of 2006. We shipped 2.7 million fewer pounds of product during the 2007 quarter than in the year-earlier quarter however, the average price per pound was $0.10 higher in the 2007 quarter. The decline in pounds shipped was substantially all in the lettuce category, as demand for lettuce decreased in 2007 as a result of public concern over food borne illness linked to contaminated produce. Additionally, we also reduced business with certain customers that were not profitable for us.

*Gross profit.* Our gross profit percentage was 7.8 percent for the 2007 quarter, compared to 1 percent a year earlier. Our gross profit increased by $944,000, due to higher overall prices per pound of items sold, and a reduction of business with certain unprofitable customers. Our average sales price for onions increased by $0.17 per pound compared with 2006 however, we believe this is a temporary episode. The 2006 Fall onion crops experienced adverse weather conditions and reduced plantings, resulting in shortages of onions in the Spring growing seasons. The Spring Mexico and Texas growing seasons also experienced adverse weather, resulting in shortages. Accordingly, the prices we paid for onions were also higher.

We were able to achieve greater production labor efficiency through improved scheduling and more efficient utilization of production labor equipment. Additionally, we were able to achieve savings on outbound freight costs, principally due to consolidations of outbound deliveries, resulting in fewer delivery miles required.

Nationally, diesel fuel prices, a major component of our shipping costs, averaged $2.81 per gallon in the second quarter of 2007, compared with $2.84 in the year-earlier quarter, according to the United States Energy Information Administration.

Our gross profit was adversely affected by a provision of $200,000 in connection with a settlement with a supplier. During the second quarter of 2007, one of our suppliers alleged that we did not purchase the required quantity of lettuce from that supplier and the supplier sought to recover its costs associated with producing or acquiring the product that it alleges we did not purchase. Subsequent to June 30, 2007, we reached a settlement with the supplier and made a provision of $200,000 during the second quarter of 2007 in recognition of this settlement.

*Selling, general and administrative expenses*. Our selling, general and administrative expenses amounted to $970,000 in the second quarter of 2007, compared with $1,177,000 in the year-earlier quarter, a decline of $207,000, or 17.6 percent. The decrease was primarily due to headcount reductions during the second and third quarters of 2006, and included reductions in administrative and sales salaries, commissions to brokers, and curtailments in sales training programs.

*Other income and expense*. Other income and expense amount to a net expense of $661,000 during the second quarter of 2007, compared to a net expense of $153,000 in the year-earlier quarter, an increase of $508,000, consisting primarily of an increase in interest expense of $525,000, and a loss on the sale of assets of $21,000.

Interest expense totaled $778,000 during the second quarter, compared to $253,000 in the year-earlier quarter. The higher interest costs were primarily attributable to higher levels of indebtedness resulting from bridge loans outstanding and higher amounts outstanding on other short-term debt resulting from our liquidity challenges in 2006 and the first six months of 2007.

As a result of the liquidity created from the proceeds the Company s initial public offering of shares on July 3, 2007, the Company s indebtedness has been substantially reduced subsequent to June 30, 2007. The pro-forma interest expense taking into account the repayment of indebtedness from a portion of the public offering proceeds would have been $258,000 and $503,000 for the second quarter and year-to-date periods of 2007.

*Income tax expense (benefit).* We recognized an income tax benefit of $98,000 during the second quarter of 2007, attributable to amortization of equity transactions, utilization of net operating loss carryforwards and other less significant items. During the second quarter of 2006, we recognized an income tax benefit of $487,000 due primarily to an operating loss, and utilization of net operating loss carryforwards.

Our income tax benefit differs from the benefit that would be expected by applying the statutory income tax rates. Our tax benefits are lower and income tax expenses are higher, resulting in effective financial accounting tax rates that are currently higher than the statutory income tax rates. The amortization of bridge loan assets in the 2007 period constitutes a permanent difference between tax return taxable income and pre-tax accounting income, resulting in a higher effective tax rate than would be expected based on the statutory income tax rates.

**Comparison of Six Months Ended June 30, 2007 and 2006**

We recorded a net loss for the first six months of 2007 of $558,000, or $0.24 per share, compared with a net loss of $448,000, or $0.19 per share during the six months ended June 30, 2006. Our operating results for the six month period were adversely affected by a provision of $200,000 in connection with a settlement with a supplier and by higher interest costs than in the corresponding period of the previous year. Operating results were positively affected by higher gross margin amounts and percentages, as a result of higher average selling prices per pound, and by reducing or terminating our relationships with unprofitable customers.

*Net sales*. Net sales increased by $161,000, or 0.6 percent in the first six months of 2007, compared to the corresponding period of 2006. We shipped 3.5 million fewer pounds of product during the 2007 period than in the year-earlier period however, the average price per pound was $0.07 higher in the 2007 period. The decline in pounds shipped was substantially all in the lettuce category, as demand for lettuce decreased in 2007 as a result of public concern over food borne illness linked to contaminated produce. Additionally, we also reduced or terminated our business with certain customers that were not profitable for us.

*Gross profit*. Our gross profit percentage was 9.3 percent for the 2007 period, compared to 7.0 percent a year earlier. Our gross profit increased by $642,000, due to higher overall prices per pound of items sold, and a reduction of business with certain unprofitable customers. We were also able to achieve greater production labor efficiency through improved scheduling and more efficient utilization of production labor equipment. Additionally, we were able to achieve savings on outbound freight costs, principally due to consolidations of outbound deliveries, resulting in fewer delivery miles required.

Diesel fuel prices, a major component of our shipping costs, averaged $2.68 per gallon in the first six months of 2007, compared with $2.67 in the year-earlier quarter, according to the United States Energy Information Administration.

Our gross profit was adversely affected by a provision of $200,000 in connection with a settlement with a supplier. During the second quarter of 2007, one of our suppliers alleged that we did not purchase the required quantity of lettuce from that supplier and the supplier sought to recover its costs associated with producing or acquiring the product that it alleges we did not purchase. Subsequent to June 30, 2007, we reached a settlement with the supplier and made a provision of $200,000 during the second quarter of 2007 in recognition of this settlement.

*Selling, general and administrative expenses*. Our selling, general and administrative expenses amounted to $1,803,000 in the first six months of 2007, compared with $2,207,000 in the year-earlier period, a decline of $404,000, or 18.3 percent. The decrease was primarily due to headcount reductions during the second and third quarters of 2006, and included reductions in administrative and sales salaries, commissions to brokers, and curtailments in sales training programs.

*Other income and expense*. Other income and expense amount to a net expense of $1,174,000 during the first six months of 2007, compared to a net expense of $321,000 in the year-earlier period, an increase of $852,000, consisting primarily of an increase in interest expense of $881,000, and a loss on the sale of assets of $21,000.

Interest expense totaled $1,397,000 during the first six months of 2007 compared to $516,000 in 2006. The higher interest costs were primarily attributable to higher levels of indebtedness resulting from bridge loans outstanding and higher amounts outstanding on other short-term debt resulting from our liquidity challenges in 2006 and the first six months of 2007.

*Income tax expense (benefit).* We recognized income tax expense of $54,000 during the first six months of 2007, attributable to amortization of equity transactions, utilization of net operating loss carryforwards and other less significant items. During the second quarter of 2006, we recognized an income tax benefit of $249,000 due primarily to an operating loss, and utilization of net operating loss carryforwards.

*Pro-forma Results*

Our pro-forma results include the following major assumptions:

a) That the initial public offering had occurred on or before January 1, 2006;

b) That Allison s had been acquired on for before January 1, 2006;

c) That we had reduced certain indebtedness - specifically that indebtedness that was retired or reduced with a portion of the proceeds of the initial public offering as of January 1, 2006 and the removal of the related amortization of the bride note asset and amortization of loan origination fees;

d) An effective income tax rate of 38 percent; and

e) That all intercompany transactions between Vaughan and Allison s had been eliminated in consolidation;

On a pro forma basis, revenues increased in the second quarter by 15.2 percent to $20.9 million, compared to $18.1 million in the second quarter of 2006. The increase in revenues was primarily attributable to the addition of Wild in

June 2006 by Allison s. Gross profit was $2.5 million, or 11.8 percent of revenues, compared to $1.1 million, or 6 percent of revenues in the same periods of the previous year. The increase in gross profit primarily resulted from revenue growth in the higher margin prepared foods business. Operating income was $694,000 compared to an operating loss of $693,000 million in 2006. This turnaround was attributable almost entirely to the gross margin improvement.

For the second quarter of 2007, we had pro forma net income of $265,000, or $0.06 per share, compared to a net loss of $529,000, or $0.12 per share in 2006.

For the six-month results, pro forma revenues were $38.7 million, up 15.5 percent compared to $33.5 million a year earlier. As with the quarter, the increase was primarily due to the addition of Wild by Allison s. Gross profit was $5.1 million, or 13.1 percent of sales, compared to $3.3 million, or 10 percent of sales in 2006. Again, the increase in gross profit primarily resulted from revenue growth in the higher margin prepared foods business. Operating profit was $1.8 million, compared to $182,000, with this increase being due entirely to gross margin.

Pro forma net income for the first six months of 2007 was $808,000, or $0.18 per share, compared to a net loss of $167,000, or $0.04 per share. Weighted average basic and diluted shares outstanding were 4.45 million for both periods.

The following table shows the pro-forma effects for the three months and six months ended June 30, 2007:

| | **Three Months Ended June 30,** | | **Six Months Ended June 30,** | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| | **(dollars in thousands, except share data)** | | | |
| Revenues | $ 20,913 | $ 18,144 | $ 38,727 | $ 33,521 |
| Gross profit | 2,466 | 1,084 | 5,084 | 3,337 |
| Operating income | $ 13,630 | | $81 | |

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The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the nine months ended September 30, 2015 and September 30, 2014 was as follows:

| ($ in thousands) | Nine Months Ended September 30, 2015 | | Nine Months Ended September 30, 2014 | |
|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Commercial | $2,234 | $ 33 | $4,039 | $ 19 |
| Commercial Real Estate | 1,180 | 38 | 3,320 | 58 |
| Agriculture | — | — | 655 | — |
| Residential Mortgage | 4,104 | 96 | 5,389 | 96 |
| Residential Construction | 879 | 27 | 925 | 29 |
| Consumer | 1,423 | 29 | 1,482 | 40 |
| Total | $9,820 | $ 223 | $15,810 | $ 242 |

None of the interest on impaired loans was recognized using a cash basis of accounting for the three and nine months ended September 30, 2015 and September 30, 2014.

Troubled Debt Restructurings

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

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

The Company had $5,621,000 and $6,712,000 in TDR loans as of September 30, 2015 and December 31, 2014, respectively. Specific reserves for TDR loans totaled $852,000 and $860,000 as of September 30, 2015 and December 31, 2014, respectively. TDR loans performing in compliance with modified terms totaled $5,480,000 and $5,467,000 as of September 30, 2015 and December 31, 2014, respectively. There were no commitments to advance more funds on existing TDR loans as of September 30, 2015.

There were no loans modified as troubled debt restructurings during the three-month periods ended September 30, 2015 and September 30, 2014.

Loans modified as TDRs during the nine months ended September 30, 2015 and September 30, 2014 were as follows:

| ($ in thousands) | Nine Months Ended September 30, 2015 | | |
|---|---|---|---|
| | Number of Contracts | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial | 1 | $ 419 | $ 419 |
| Consumer | 1 | 109 | 109 |
| Total | 2 | $ 528 | $ 528 |

| ($ in thousands) | Nine Months Ended September 30, 2014 | | |
|---|---|---|---|
| | Number of Contracts | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial | 1 | $ 49 | $ 49 |
| Consumer | 2 | 498 | 498 |
| Total | 3 | $ 547 | $ 547 |

The loan modifications generally involved reductions in the interest rate, payment extensions, forgiveness of principal, and forbearance. There were no loans modified as a TDR within the previous 12 months and for which there was a payment default during the three and nine months ended September 30, 2015. There was one consumer loan with a recorded investment of $49,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the three-month and nine-month periods ended September 30, 2014.

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 an 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, 2014.

The following table presents the risk ratings by loan class as of September 30, 2015 and December 31, 2014:

| ($ in thousands) | Pass | Special Mention | Substandard | Doubtful | Loss | Total |
|---|---|---|---|---|---|---|
| September 30, 2015 | | | | | | |
| Commercial | $116,571 | $11,547 | $ 1,496 | $ — | $ — | $129,614 |
| Commercial Real Estate | 275,822 | 16,618 | 3,981 | — | — | 296,421 |
| Agriculture | 74,138 | — | — | — | — | 74,138 |
| Residential Mortgage | 41,511 | 376 | 779 | — | — | 42,666 |
| Residential Construction | 10,732 | 458 | 123 | — | — | 11,313 |
| Consumer | 43,570 | 348 | 1,761 | — | — | 45,679 |
| Total | $562,344 | $29,347 | $ 8,140 | $ — | $ — | $599,831 |
| | | | | | | |
| December 31, 2014 | | | | | | |
| Commercial | $112,751 | $3,255 | $ 4,745 | $ — | $ — | $120,751 |
| Commercial Real Estate | 240,808 | 10,607 | 5,540 | — | — | 256,955 |
| Agriculture | 61,144 | — | — | — | — | 61,144 |
| Residential Mortgage | 46,043 | 997 | 3,471 | — | — | 50,511 |
| Residential Construction | 5,386 | 467 | 110 | — | — | 5,963 |
| Consumer | 46,234 | 944 | 2,733 | — | — | 49,911 |
| Total | $512,366 | $16,270 | $ 16,599 | $ — | $ — | $545,235 |

Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2015.

Three months ended September 30, 2015

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance as of June 30, 2015 | $ 3,259 | $ 2,888 | $ 852 | $ 833 | $ 144 | $ 647 | $ 483 | $9,106 |
| Provision for loan losses | (128) | 454 | 75 | (98) | 171 | 57 | (231) | 300 |
| Charge-offs | (14) | — | — | — | — | (67) | — | (81) |
| Recoveries | 3 | 13 | — | 1 | 1 | 17 | — | 35 |
| Net charge-offs | (11) | 13 | — | 1 | 1 | (50) | — | (46) |
| Balance as of September 30, 2015 | $ 3,120 | $ 3,355 | $ 927 | $ 736 | $ 316 | $ 654 | $ 252 | $9,360 |

Nine months ended September 30, 2015

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance as of December 31, 2014 | $ 3,581 | $ 1,825 | $ 580 | $ 1,181 | $ 161 | $ 886 | $ 369 | $8,583 |
| Provision for loan losses | (537) | 1,513 | 347 | (529) | 97 | (124) | (117) | 650 |
| Charge-offs | (14) | — | — | (132) | — | (152) | — | (298) |
| Recoveries | 90 | 17 | — | 216 | 58 | 44 | — | 425 |
| Net recoveries | 76 | 17 | — | 84 | 58 | (108) | — | 127 |
| Balance as of September 30, 2015 | $ 3,120 | $ 3,355 | $ 927 | $ 736 | $ 316 | $ 654 | $ 252 | $9,360 |

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, 2015.

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Period-end amount allocated to: | | | | | | | | |
| Loans individually evaluated for impairment | $ 51 | $ 42 | $ — | $ 619 | $ 114 | $ 26 | $ — | $852 |
| Loans collectively evaluated for impairment | 3,069 | 3,313 | 927 | 117 | 202 | 628 | 252 | 8,508 |
| Ending Balance | $ 3,120 | $ 3,355 | $ 927 | $ 736 | $ 316 | $ 654 | $ 252 | $9,360 |

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The following table details activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2014.

Three months ended September 30, 2014

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance as of June 30, 2014 | $ 3,471 | $ 1,691 | $ 439 | $ 1,126 | $ 196 | $ 1,013 | $ 238 | $ 8,174 |
| Provision for loan losses | 314 | (66 ) | 108 | 53 | (77 ) | (58 ) | 126 | 400 |
| Charge-offs | (203 ) | — | — | — | — | (50 ) | — | (253 ) |
| Recoveries | 12 | — | — | — | 42 | 27 | — | 81 |
| Net charge-offs | (191 ) | — | — | — | 42 | (23 ) | — | (172 ) |
| Balance as of September 30, 2014 | $ 3,594 | $ 1,625 | $ 547 | $ 1,179 | $ 161 | $ 932 | $ 364 | $ 8,402 |

Nine months ended September 30, 2014

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance as of December 31, 2013 | $ 3,199 | $ 2,290 | $ 557 | $ 1,216 | $ 441 | $ 1,023 | $ 627 | $ 9,353 |
| Provision for loan losses | 2,637 | (596 ) | (10 ) | (37 ) | (325 ) | 194 | (263 ) | 1,600 |
| Charge-offs | (2,288 ) | (69 ) | — | — | — | (378 ) | — | (2,735) |
| Recoveries | 46 | — | — | — | 45 | 93 | — | 184 |
| Net charge-offs | (2,242 ) | (69 ) | — | — | 45 | (285 ) | — | (2,551) |
| Balance as of September 30, 2014 | $ 3,594 | $ 1,625 | $ 547 | $ 1,179 | $ 161 | $ 932 | $ 364 | $ 8,402 |

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, 2014.

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Period-end amount allocated to: | | | | | | | | |
| Loans individually evaluated for impairment | $ 36 | $ 56 | $ — | $ 645 | $ 111 | $ 22 | $ — | $ 870 |
| Loans collectively evaluated for impairment | 3,558 | 1,569 | 547 | 534 | 50 | 910 | 364 | 7,532 |
| Ending Balance | $ 3,594 | $ 1,625 | $ 547 | $ 1,179 | $ 161 | $ 932 | $ 364 | $ 8,402 |

The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the year ended December 31, 2014.

Year ended December 31, 2014

| ($ in thousands) | Commercial | Commercial Real Estate | Agriculture | Residential Mortgage | Residential Construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance as of December 31, 2013 | $ 3,199 | $ 2,290 | $ 557 | $ 1,216 | $ 441 | $ 1,023 | $ 627 | $ 9,353 |
| Provision for (reversal of) loan losses | 2,612 | (396 ) | 23 | 36 | (366 ) | 149 | (258 ) | 1,800 |
| Charge-offs | (2,288 ) | (69 ) | — | (71 ) | — | (393 ) | — | (2,821) |
| Recoveries | 58 | — | — | — | 86 | 107 | — | 251 |
| Net charge-offs | (2,230 ) | (69 ) | — | (71 ) | 86 | (286 ) | — | (2,570) |
| Ending Balance | $ 3,581 | $ 1,825 | $ 580 | $ 1,181 | $ 161 | $ 886 | $ 369 | $ 8,583 |
| Period-end amount allocated to: | | | | | | | | |
| Loans individually evaluated for impairment | $ 39 | $ 45 | $ — | $ 646 | $ 107 | $ 23 | $ — | $ 860 |
| Loans collectively evaluated for impairment | 3,542 | 1,780 | 580 | 535 | 54 | 863 | 369 | 7,723 |
| Balance as of December 31, 2014 | $ 3,581 | $ 1,825 | $ 580 | $ 1,181 | $ 161 | $ 886 | $ 369 | $ 8,583 |

The Company's investment in loans as of September 30, 2015, September 30, 2014, and December 31, 2014 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, 2015 | | | | | | | |
| Loans individually evaluated for impairment | $ 959 | $ 1,578 | $ — | $ 3,360 | $ 860 | $ 1,329 | $ 8,086 |
| Loans collectively evaluated for impairment | 128,655 | 294,843 | 74,138 | 39,306 | 10,453 | 44,350 | 591,745 |
| Ending Balance | $ 129,614 | $ 296,421 | $ 74,138 | $ 42,666 | $ 11,313 | $ 45,679 | $ 599,831 |
| September 30, 2014 | | | | | | | |
| Loans individually evaluated for impairment | $ 2,738 | $ 2,740 | $ — | $ 5,267 | $ 908 | $ 1,686 | $ 13,339 |
| Loans collectively evaluated for impairment | 114,503 | 251,220 | 55,293 | 44,204 | 4,487 | 48,812 | 518,519 |
| Ending Balance | $ 117,241 | $ 253,960 | $ 55,293 | $ 49,471 | $ 5,395 | $ 50,498 | $ 531,858 |
| December 31, 2014 | | | | | | | |
| Loans individually evaluated for impairment | $ 2,678 | $ 976 | $ — | $ 4,647 | $ 897 | $ 1,506 | $ 10,704 |
| Loans collectively evaluated for impairment | 118,073 | 255,979 | 61,144 | 45,864 | 5,066 | 48,405 | 534,531 |
| Ending Balance | $ 120,751 | $ 256,955 | $ 61,144 | $ 50,511 | $ 5,963 | $ 49,911 | $ 545,235 |

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, 2015 for cash proceeds equal to the fair value of the loans.

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

Key assumptions used in measuring the fair value of mortgage servicing rights as of September 30, 2015 and December 31, 2014 were as follows:

| | September 30, 2015 | December 31, 2014 |
|---|---|---|
| Constant prepayment rate | 11.38 % | 12.12 % |
| Discount rate | 10.55 % | 10.06 % |
| Weighted average life (years) | 6.33 | 6.25 |

At September 30, 2015 and December 31, 2014, the Company's mortgage loans held-for-sale were $1,241,000 and $491,000, respectively. At September 30, 2015, and December 31, 2014, the Company serviced real estate mortgage loans for others totaling $237,903,000 and $238,974,000, respectively.

The following table summarizes the Company's mortgage servicing rights assets as of September 30, 2015 and December 31, 2014. Mortgage servicing rights are included in Interest Receivable and Other Assets on the condensed consolidated balance sheets:

| | (in thousands) December 31, 2014 | Additions | Reductions | September 30, 2015 |
|---|---|---|---|---|
| Mortgage servicing rights | $1,862 | $ 304 | $ (277 ) | $ 1,889 |
| Valuation allowance | — | — | — | — |
| Mortgage servicing rights, net of valuation allowance | $1,862 | $ 304 | $ (277 ) | $ 1,889 |

At September 30, 2015 and December 31, 2014, the estimated fair value of the Company's mortgage servicing rights asset was $2,019,000 and $2,068,000, respectively.

The Company received contractually specified servicing fees of $150,000 and $152,000 for the three months ended September 30, 2015 and September 30, 2014, respectively. The Company received contractually specified servicing fees of $450,000 and $456,000 for the nine months ended September 30, 2015 and September 30, 2014, respectively. Contractually specified servicing fees are included in non-interest income on the condensed consolidated statements of income, net of the amortization of the mortgage servicing rights asset.

4. OUTSTANDING SHARES AND EARNINGS PER SHARE

On January 22, 2015, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2015. All income per share amounts have been adjusted to give retroactive effect to stock dividends.

Earnings Per Share (EPS)

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

The following table presents a reconciliation of basic and diluted EPS for the three and nine months ended September 30, 2015 and 2014.

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| Basic earnings per share: | | | | |
| Net income | $1,819 | $1,570 | $5,106 | $4,273 |
| Preferred stock dividend | $(32) | $(33) | $(96) | $(97) |
| Net income available to common stockholders | $1,787 | $1,537 | $5,010 | $4,176 |
| Weighted average common shares outstanding | 10,170,848 | 10,119,433 | 10,159,119 | 10,114,976 |
| Basic EPS | $0.18 | $0.15 | $0.49 | $0.41 |
| Diluted earnings per share: | | | | |
| Net income | $1,819 | $1,570 | $5,106 | $4,273 |
| Preferred stock dividend | $(32) | $(33) | $(96) | $(97) |
| Net income available to common stockholders | $1,787 | $1,537 | $5,010 | $4,176 |
| Weighted average common shares outstanding | 10,170,848 | 10,119,433 | 10,159,119 | 10,114,976 |
| Effect of dilutive shares | 57,036 | 54,538 | 56,300 | 51,515 |
| Adjusted weighted average common shares outstanding | 10,227,884 | 10,173,971 | 10,215,419 | 10,166,491 |
| Diluted EPS | $0.17 | $0.15 | $0.49 | $0.41 |

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 157,489 shares and 229,286 shares for the three months ended September 30, 2015 and 2014, 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 168,321 shares and 245,582 shares for the nine months ended September 30, 2015 and 2014, 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 months ended September 30, 2015 and 2014. 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 zero shares and 8,533 shares for the nine months ended September 30, 2015 and 2014, respectively.

5. STOCK PLANS

On January 22, 2015, the Board of Directors of the Company declared a 4% stock dividend payable as of March 31, 2015. 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, 2015.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 228,693 | $ 11.49 | | |
| Granted | — | — | | |
| Expired | (6,832 ) | $ 17.18 | | |
| Cancelled / Forfeited | — | — | | |
| Exercised | — | — | | |
| Options outstanding at End of Period | 221,861 | $ 11.32 | $243,197 | 4.58 |
| Exercisable (vested) at End of Period | 150,212 | $ 13.39 | $172,559 | 2.62 |

The following table presents the activity related to stock options for the nine months ended September 30, 2015.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Term (in years) |
|---|---|---|---|---|
| Options outstanding at Beginning of Period | 313,483 | $ 11.54 | | |
| Granted | 41,047 | $ 7.60 | | |
| Expired | (101,441) | $ 11.35 | | |
| Cancelled / Forfeited | (11,382 ) | $ 16.28 | | |
| Exercised | (19,846 ) | $ 4.23 | | |
| Options outstanding at End of Period | 221,861 | $ 11.32 | $243,197 | 4.58 |
| Exercisable (vested) at End of Period | 150,212 | $ 13.39 | $172,559 | 2.62 |

The weighted average grant date fair value per share of options granted during the nine months ended September 30, 2015 was $2.67 per share.

As of September 30, 2015, there was $150,000 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 $48,000 of recognized compensation cost related to stock options granted for the nine months ended September 30, 2015.

A summary of the weighted average assumptions used in valuing stock options during the three and nine months ended September 30, 2015 is presented below.

| | Three Months Ended September 30, 2015* | Nine Months Ended September 30, 2015 |
|---|---|---|
| Risk Free Interest Rate | — | 1.61 % |
| Expected Dividend Yield | — | 0.00 % |
| Expected Life in Years | — | 5 |
| Expected Price Volatility | — | 37.38 % |

*There were no stock options granted during the three months ended September 30, 2015.

The following table presents the activity related to non-vested restricted stock for the three months ended September 30, 2015.

| | 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 | 85,579 | $ 6.54 | | |
| Granted | — | — | | |
| Cancelled / Forfeited | (312 ) | $ 7.60 | | |
| Exercised/Released/Vested | — | — | | |
| Non-vested restricted stock outstanding at End of Period | 85,267 | $ 6.53 | $ 677,873 | 8.24 |

The following table presents the activity related to non-vested restricted stock for the nine months ended September 30, 2015.

| | 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 | 73,827 | $ 5.64 | | |
| Granted | 30,056 | $ 7.59 | | |
| Cancelled / Forfeited | (312 ) | $ 7.60 | | |

| | | | | |
|---|---|---|---|---|
| Exercised/Released/Vested | (18,304) | $ 4.66 | | |
| Non-vested restricted stock outstanding at End of Period | 85,267 | $ 6.53 | $ 677,873 | 8.24 |

The weighted average fair value of restricted stock granted during the nine months ended September 30, 2015 was $7.59 per share.

As of September 30, 2015, there was $328,000 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 2.75 years. There was $107,000 of recognized compensation cost related to restricted stock awards for the nine months ended September 30, 2015.

The Company has an Employee Stock Purchase Plan ("ESPP"). Under the ESPP, the Company is authorized to issue shares of common stock to eligible employees. There are 322,385 (adjusted for the March 2015 stock dividend) shares authorized under the 2006 Amended ESPP. The 2006 Amended ESPP will expire on March 15, 2016. In May 2015, the Company's shareholders approved the 2016 ESPP, which will become effective on March 16, 2016. There are 250,000 shares authorized under the 2016 ESPP, which include authorized but unissued shares under the 2006 Amended ESPP. The 2016 ESPP will expire on March 16, 2026. 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, 2014 to November 23, 2015. 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, 2015, there was $4,000 of unrecognized compensation cost related to ESPP issuances. This cost is expected to be recognized over a weighted average period of approximately 0.25 years.

There was $19,000 of recognized compensation cost related to ESPP issuances for the nine months ended September 30, 2015.

The weighted average fair value at issuance date during the nine months ended September 30, 2015 was $1.67.

A summary of the weighted average assumptions used in valuing ESPP issuances during the three and nine months ended September 30, 2015 is presented below.

| | Three Months Ended September 30, 2015 | | Nine Months Ended September 30, 2015 | |
|---|---|---|---|---|
| Risk Free Interest Rate | 0.14 | % | 0.14 | % |
| Expected Dividend Yield | 0.00 | % | 0.00 | % |
| Expected Life in Years | 1.00 | | 1.00 | |
| Expected Price Volatility | 15.10 | % | 15.10 | % |

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, 2015 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, 2015, 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.

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, 2015:

| | (in thousands) | | | |
|---|---|---|---|---|
| September 30, 2015 | Total | Level 1 | Level 2 | Level 3 |
| Securities of U.S. government agencies and corporations | $13,189 | $ — | $13,189 | $ — |
| Obligations of states and political subdivisions | 20,845 | — | 20,845 | — |
| Collateralized mortgage obligations | 11,857 | — | 11,857 | — |
| Mortgage-backed securities | 88,691 | — | 88,691 | — |
| Total investments at fair value | $134,582 | $ — | $134,582 | $ — |

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

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2014:

| | (in thousands) | | | |
|---|---|---|---|---|
| December 31, 2014 | Total | Level 1 | Level 2 | Level 3 |
| Securities of U.S. government agencies and corporations | $28,429 | $ — | $28,429 | $ — |
| Obligations of states and political subdivisions | 20,763 | — | 20,763 | — |
| Collateralized mortgage obligations | 12,553 | — | 12,553 | |
| Mortgage-backed securities | 89,481 | — | 89,481 | — |
| Total investments at fair value | $151,226 | $ — | $151,226 | $ — |

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, 2015:

| | (in thousands) | | | |
|---|---|---|---|---|
| September 30, 2015 | Total | Level 1 | Level 2 | Level 3 |
| Impaired loans | $69 | — | — | $69 |
| Total assets at fair value | $69 | $ — | $ — | $69 |

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, 2014:

| | (in thousands) | | | |
|---|---|---|---|---|
| December 31, 2014 | Total | Level 1 | Level 2 | Level 3 |
| Impaired loans | $568 | $ — | $ — | $568 |
| Other real estate owned | 736 | — | — | 736 |
| Total assets at fair value | $1,304 | $ — | $ — | $1,304 |

There were no liabilities measured at fair value on a recurring or non-recurring basis at September 30, 2015 and December 31, 2014.

Key methods and assumptions used in measuring the fair value of impaired loans and OREO as of September 30, 2015 and December 31, 2014 were as follows:

| | Method | Assumption Inputs |
|---|---|---|
| Impaired loans | Collateral, market, income, enterprise, liquidation and discounted Cash Flows | External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 7%. |
| Other real estate owned | Collateral | External appraised values, management assumptions regarding market trends or other relevant factors; selling costs ranging 6% to 11%. |

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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.

On October 26, 2015, the Company redeemed the remaining $12,847,000 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 & Cash Equivalents and Certificates of Deposit

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

Stock in Federal Home Loan Bank and other equity securities, at cost

The carrying amounts reported in the condensed consolidated balance sheets approximate fair value as the shares can only be redeemed by the issuing institution. The Company believes the measurement of the fair value of other equity securities is derived from Level 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, the fair value is based on what secondary markets are currently offering for portfolios with similar characteristics. See Note 6, Fair Value Measurement included in these notes to unaudited condensed consolidated financial statements.

Mortgage Servicing Rights

The Company measures fair value of mortgage servicing rights using Level 2 and Level 3 inputs. 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 MSR, 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. This model is periodically validated by an independent external model validation group. The model assumptions and the MSR fair value estimates are also compared to observable trades of similar portfolios as well as to MSR broker valuations and industry surveys, as available.

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.

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, 2015 and December 31, 2014 are approximately as follows:

| | | September 30, 2015 | | December 31, 2014 | |
|---|---|---|---|---|---|
| | Level | Carrying amount | Fair value | Carrying amount | Fair value |
| Financial assets: | | | | | |
| Cash and cash equivalents | 1 | $261,314 | $261,314 | $216,192 | $216,192 |
| Certificates of deposit | 1 | 11,937 | 11,937 | 12,860 | 12,860 |
| Stock in FHLB and other equity securities, at cost | 2 | 3,934 | 3,934 | 3,934 | 3,934 |
| Loans receivable: | | | | | |
| Net loans | 3 | 591,503 | 588,749 | 537,979 | 535,018 |
| Loans held-for-sale | 2 | 1,241 | 1,277 | 491 | 509 |
| Interest receivable | 2 | 2,911 | 2,911 | 2,650 | 2,650 |
| Mortgage servicing rights | 3 | 1,889 | 2,019 | 1,862 | 2,068 |
| Financial liabilities: | | | | | |
| Deposits | 3 | 931,348 | 901,623 | 857,052 | 837,150 |
| Interest payable | 2 | 87 | 87 | 70 | 70 |

9. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at September 30, 2015 are summarized as follows:

| (in thousands) | Amortized cost | Unrealized gains | Unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Investment securities available-for-sale: | | | | |
| Securities of U.S. government agencies and corporations | $ 13,158 | $ 44 | $ (13 ) | $ 13,189 |
| Obligations of states and political subdivisions | 20,378 | 483 | (16 ) | 20,845 |
| Collateralized mortgage obligations | 11,791 | 67 | (1 ) | 11,857 |
| Mortgage-backed securities | 88,508 | 494 | (311 ) | 88,691 |
| Total debt securities | $ 133,835 | $ 1,088 | $ (341 ) | $ 134,582 |

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2014 are summarized as follows:

| (in thousands) | Amortized cost | Unrealized gains | Unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Investment securities available-for-sale: | | | | |
| Securities of U.S. government agencies and corporations | $ 28,787 | $ 17 | $ (375 ) | $ 28,429 |
| Obligations of states and political subdivisions | 20,236 | 579 | (52 ) | 20,763 |
| Collateralized mortgage obligations | 12,541 | 37 | (25 ) | 12,553 |
| Mortgage-backed securities | 88,491 | 1,144 | (154 ) | 89,481 |
| Total debt securities | $ 150,055 | $ 1,777 | $ (606 ) | $ 151,226 |

The Company had $17,798,000 in proceeds from sales of available-for-sale securities for each of the three and nine months ended September 30, 2015. The Company had $12,140,000 in proceeds from sales of available-for-sale securities for each of the three and nine months ended September 30, 2014. Gross realized gains from sales or calls of available-for-sale securities were $68,000 for each of the three and nine months ended September 30, 2015. Gross realized gains from sales or calls of available-for-sale securities were $292,000 for each of the three and nine months ended September 30, 2014. Gross realized losses from sales or calls of available-for-sale securities were $39,000 for each of the three and nine months ended September 30, 2015. Gross realized losses from sales or calls of available-for-sale securities were $239,000 for each of the three and nine months ended September 30, 2014. There was a $12,000 recovery from other equity securities for each of the three months and nine months ended September 30, 2015. There was $0 and $50,000 gross realized loss from other equity securities for the three months and nine months ended September 30, 2014, respectively.

The amortized cost and estimated fair value of debt and other securities at September 30, 2015, by contractual and expected maturity, are shown in the following table:

| (in thousands) | Amortized cost | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 4,566 | $ 4,577 |
| Due after one year through five years | 117,480 | 117,898 |

| | | |
|---|---|---|
| Due after five years through ten years | 10,565 | 10,844 |
| Due after ten years | 1,224 | 1,263 |
| | $ 133,835 | $ 134,582 |

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 and collateralized mortgage obligations with expected maturities totaling $99,469,000 at September 30, 2015. 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, 2015, follows:

| (in thousands) | Less than 12 months Fair Value | Less than 12 months Unrealized losses | 12 months or more Fair Value | 12 months or more Unrealized losses | Total Fair Value | Total Unrealized losses |
|---|---|---|---|---|---|---|
| Securities of U.S. government agencies and corporations | $- | $ - | $6,089 | $ (13 ) | $6,089 | $ (13 ) |
| Obligations of states and political subdivisions | 1,703 | (16 ) | - | - | 1,703 | (16 ) |
| Collateralized Mortgage obligations | 486 | (1 ) | - | - | 486 | (1 ) |
| Mortgaged-backed securities | 37,212 | (219 ) | 6,233 | (92 ) | 43,445 | (311 ) |
| Total | $39,401 | $ (236 ) | $12,322 | $ (105 ) | $51,723 | $ (341 ) |

No decline in value was considered "other-than-temporary" during the first nine months of 2015. Thirty-nine securities, all considered investment grade, which had a fair value of $39,401,000 and a total unrealized loss of $236,000, have been in an unrealized loss position for less than twelve months as of September 30, 2015. Twelve securities, all considered investment grade, which had a fair value of $12,322,000 and a total unrealized loss of $105,000, have been in an unrealized loss position for more than twelve months as of September 30, 2015. The declines in fair value were attributable to changes in interest rates. We have evaluated the credit ratings of our investment securities and their issuer and/or insurers, and based on this evaluation have determined that no investment security in our investment portfolio is other-than-temporarily impaired. 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, 2014, follows:

| | Less than 12 months Fair Value | Less than 12 months Unrealized losses | 12 months or more Fair Value | 12 months or more Unrealized losses | Total Fair Value | Total Unrealized losses |
|---|---|---|---|---|---|---|
| Securities of U.S. government agencies and corporations | $1,474 | $ (4 ) | $21,729 | $ (371 ) | $23,203 | $ (375 ) |
| Obligations of states and political subdivisions | 1,927 | (28 ) | 1,530 | (24 ) | 3,457 | (52 ) |
| Collateralized Mortgage obligations | 2,881 | (25 ) | — | — | 2,881 | (25 ) |
| Mortgage-backed securities | 9,786 | (55 ) | 9,128 | (99 ) | 18,914 | (154 ) |
| Total | $16,068 | $ (112 ) | $32,387 | $ (494 ) | $48,455 | $ (606 ) |

Investment securities carried at $30,902,000 and $27,868,000 at September 30, 2015 and December 31, 2014, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table details activity in accumulated other comprehensive loss for the three months ended September 30, 2015.

| ($ in thousands) | Unrealized Gains on Securities | Officers' retirement plan | Directors' retirement plan | Accumulated Other Comprehensive Income/(loss) |
|---|---|---|---|---|
| Balance as of June 30, 2015 | $ 460 | $ (678) | $ 8 | $ (210) |
| Current period other comprehensive loss | (12) | — | — | (12) |
| Balance as of September 30, 2015 | $ 448 | $ (678) | $ 8 | $ (222) |

The following table details activity in accumulated other comprehensive income (loss) for the nine months ended September 30, 2015.

| ($ in thousands) | Unrealized Gains on Securities | Officers' retirement plan | Directors' retirement plan | Accumulated Other Comprehensive Income/(loss) |
|---|---|---|---|---|
| Balance as of December 31, 2014 | $ 703 | $ (678) | $ 41 | $ 66 |
| Current period other comprehensive loss | (255) | — | (33) | (288) |
| Balance as of September 30, 2015 | $ 448 | $ (678) | $ 8 | $ (222) |

The following table details activity in accumulated other comprehensive income (loss) for the three months ended September 30, 2014.

| ($ in thousands) | Unrealized Gains on Securities | Officers' retirement plan | Directors' retirement plan | Accumulated Other Comprehensive Income/(loss) |
|---|---|---|---|---|
| Balance as of June 30, 2014 | $ 638 | $ (480) | $ 46 | $ 204 |
| Current period other comprehensive loss | (228) | — | — | (228) |
| Balance as of September 30, 2014 | $ 410 | $ (480) | $ 46 | $ (24) |

The following table details activity in accumulated other comprehensive loss for the nine months ended September 30, 2014.

| ($ in thousands) | Unrealized Gains on Securities | Officers' retirement plan | Directors' retirement plan | Accumulated Other Comprehensive Income/(loss) |
|---|---|---|---|---|
| Balance as of December 31, 2013 | $ (639) | $ (480) | $ 46 | $ (1,073) |
| Current period other comprehensive income | 1,049 | — | — | 1,049 |
| Balance as of September 30, 2014 | $ 410 | $ (480) | $ 46 | $ (24) |

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, 2015 | December 31, 2014 |
|---|---|---|
| Undisbursed loan commitments | $ 206,225 | $ 171,019 |
| Standby letters of credit | 2,972 | 2,099 |
| Commitments to sell loans | 2,137 | 1,230 |
| | $ 211,334 | $ 174,348 |

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, 2015, 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, 2015, there was $2,972,000 issued in performance standby letters of credit. At September 30, 2015, the Bank had experienced no draws on these letters of credit, resulting in no related liability included on its balance sheet, however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of $793,000 at September 30, 2015, which is recorded in "interest payable and other liabilities" on the Condensed Consolidated Balance Sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of September 30, 2015, 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 was 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 may include forecasts of our financial results and condition, expectations for our operations and business, and our assumptions for those forecasts and expectations. Do not rely unduly on forward-looking statements. Actual results might differ significantly compared to our forecasts and expectations. See Part I, Item 1A. "Risk Factors," and the other risks described in our 2014 Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q for factors to be considered when reading any forward-looking statements in this filing.

This report and other reports or statements which we may release 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 and prospects, and the affect of competition on our business and strategies

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

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

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

The costs and effects of legal or regulatory actions

Expectations regarding draws on performance letters of credit

Our regulatory capital requirements, including the recently adopted capital rules by the U.S. federal banking agencies

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

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Credit quality and provision for credit losses and management of asset quality and credit risk

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

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

The seasonal nature of our business

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

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

Our deposit base including renewal of time deposits

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

Expectations regarding an increase or decrease in unrecognized tax benefits

Our pension and retirement plan costs

Our liquidity position

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

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

The possible impact of the California drought and related governmental responses on economic conditions, especially in the agricultural sector

Maintenance of insurance coverage appropriate for our operations

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

Descriptions of assumptions underlying or relating to any of the foregoing

Readers of this document should not rely on any forward-looking statements, which reflect only our management's belief as of the date of this report. There are numerous risks and uncertainties that could and will cause actual results to differ materially from those discussed in our forward-looking statements. Many of these factors are beyond our ability to control or predict and could have a material adverse effect on our financial condition and results of operations or prospects. Such risks and uncertainties include, but are not limited to those listed in Item 1A "Risk Factors" of Part II of this Form 10-Q, Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I of this Form 10-Q and "Risk Factors" and "Supervision and Regulation" in our 2014 Annual Report on Form 10-K, and in our other reports to the SEC.

INTRODUCTION

This overview of Management's Discussion and Analysis highlights selected information in this report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire report and any other reports to the Securities and Exchange Commission ("SEC"), together with our Consolidated Financial Statements and the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2014.

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

Significant results and developments during the third quarter and year-to-date 2015 included:

Net income of $5.1 million for the nine months ended September 30, 2015, up 18.6% from $4.3 million earned for the same period last year.

Net income available to common shareholders of $5.0 million for the nine months ended September 30, 2015, up 19.0% from $4.2 million for the same period last year.

Diluted income per share for the nine months ended September 30, 2015 was $0.49, up 19.5% from diluted income per share of $0.41 in the same period last year.

Net interest income increased in the nine months ended September 30, 2015 by $1.5 million, or 6.8%, to $23.5 million from $22.0 million in the same period last year. The increase in net interest income was primarily due to an increase in interest income on loans and other interest-earning assets and a decrease in interest expense, which was partially offset by a decrease in interest income on investment securities. The increase in interest income on loans was primarily due to an increase in average loans, partially offset by a decrease in interest yield. The increase in interest income on other interest-earning assets was primarily due to a special dividend paid by the FHLB in the current year. The decrease in interest expense was primarily due to a decrease in interest yield, partially offset by an increase in average balance. The decrease in interest income on investment securities was due to a decrease in average balance and interest yield.

Net interest margin increased from 3.33% for the nine months ended September 30, 2014 to 3.34% for the same period ended September 30, 2015.

Provision for loan losses of $0.7 million for the nine months ended September 30, 2015, compared to a provision for loan losses of $1.6 million for the same period in 2014.

Total assets at September 30, 2015 were $1 billion, an increase of $79.8 million, or 8.3%, compared to total assets at December 31, 2014.

Total net loans at September 30, 2015 (including loans held-for-sale) increased $54.3 million, or 10.1%, to $592.7 million compared to December 31, 2014.

Total investment securities at September 30, 2015 decreased $16.6 million, or 11.0%, to $134.6 million compared to December 31, 2014.

Total deposits of $931.3 million at September 30, 2015, represented an increase of $74.3 million, or 8.7%, compared to December 31, 2014.

Net income of $1.8 million for the three months ended September 30, 2015, up 12.5% from $1.6 million for the same period last year.

Net income available to common shareholders of $1.8 million for the three months ended September 30, 2015, up 20.0% from $1.5 million for the same period last year.

Diluted income per share for the three months ended September 30, 2015 was $0.17, up 13.3% from diluted income per share of $0.15 in the same period last year.

SUMMARY

The Company recorded net income of $5,106,000 for the nine months ended September 30, 2015, representing an increase of $833,000 or 19.5% from net income of $4,273,000 for the same period in 2014. The Company recorded net income of $1,819,000 for the three months ended September 30, 2015, representing an increase of $249,000 or 15.9% from net income of $1,570,000 for the same period in 2014.

The following tables present a summary of the results for the three and nine months ended September 30, 2015 and 2014, and a summary of financial condition at September 30, 2015 and December 31, 2014.

| | Three months ended September 30, 2015 | Three months ended September 30, 2014 | Nine months ended September 30, 2015 | Nine months ended September 30, 2014 |
|---|---|---|---|---|
| (in thousands except for per share amounts) | | | | |
| For the Period: | | | | |
| Net Income | $ 1,819 | $ 1,570 | $ 5,106 | $ 4,273 |
| Net Income Available to Common Shareholders | $ 1,787 | $ 1,537 | $ 5,010 | $ 4,176 |
| Basic Earnings Per Common Share | $ 0.18 | $ 0.15 | $ 0.49 | $ 0.41 |
| Diluted Earnings Per Common Share | $ 0.17 | $ 0.15 | $ 0.49 | $ 0.41 |

| | September 30, 2015 | December 31, 2014 |
|---|---|---|
| (in thousands except for ratios) | | |
| At Period End: | | |
| Total Assets | $1,037,676 | $957,884 |
| Total Loans, Net (including loans held-for-sale) | $592,744 | $538,470 |
| Total Investment Securities | $134,582 | $151,226 |
| Total Deposits | $931,348 | $857,052 |
| Loan-To-Deposit Ratio | 63.6 % | 62.8 % |

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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, 2015 | | | Three months ended September 30, 2014 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Rate (4) | Average Balance | Interest | Yield/ Rate (4) |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) | $578,417 | $7,480 | 5.13 % | $517,208 | $6,717 | 5.15 % |
| Certificate of deposits | 11,937 | 21 | 0.70 % | 11,373 | 21 | 0.73 % |
| Interest bearing due from banks | 215,240 | 124 | 0.23 % | 194,567 | 111 | 0.23 % |
| Investment securities, taxable | 137,341 | 631 | 1.82 % | 148,996 | 741 | 1.97 % |
| Investment securities, non-taxable (2) | 8,691 | 68 | 3.10 % | 8,919 | 85 | 3.78 % |
| Other interest earning assets | 3,934 | 97 | 9.78 % | 3,934 | 77 | 7.77 % |
| Total average interest-earning assets | 955,560 | 8,421 | 3.50 % | 884,997 | 7,752 | 3.48 % |
| Non-interest-earning assets: | | | | | | |
| Cash and due from banks | 25,157 | | | 17,133 | | |
| Premises and equipment, net | 7,056 | | | 7,366 | | |
| Other real estate owned | 332 | | | 367 | | |
| Interest receivable and other assets | 25,391 | | | 26,142 | | |
| Total average assets | 1,013,496 | | | 936,005 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing transaction deposits | 246,309 | 67 | 0.11 % | 218,712 | 75 | 0.14 % |
| Savings and MMDA's | 275,014 | 121 | 0.17 % | 257,585 | 142 | 0.22 % |
| Time, under $250,000 | 62,320 | 64 | 0.41 % | 66,018 | 66 | 0.40 % |
| Time, $250,000 and over | 20,330 | 19 | 0.37 % | 23,449 | 29 | 0.49 % |
| Total average interest-bearing liabilities | 603,973 | 271 | 0.18 % | 565,764 | 312 | 0.22 % |
| Non-interest-bearing liabilities: | | | | | | |
| Non-interest-bearing demand deposits | 304,202 | | | 272,697 | | |
| Interest payable and other liabilities | 8,787 | | | 7,606 | | |
| Total liabilities | 916,962 | | | 846,067 | | |
| Total average stockholders' equity | 96,534 | | | 89,938 | | |
| Total average liabilities and stockholders' equity | $1,013,496 | | | $936,005 | | |
| Net interest income and net interest margin (3) | | $8,150 | 3.38 % | | $7,440 | 3.34 % |

(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 $368 and $229 for the three months ended September 30, 2015 and 2014, respectively.
(2) Interest income and yields on tax-exempt securities are not presented on a taxable-equivalent basis.
(3) Net interest margin is computed by dividing net interest income by total average interest-earning assets.
(4) For disclosure purposes, yield /rates are annualized by dividing the number of days in the reported period by 365.

FIRST NORTHERN COMMUNITY BANCORP

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

| | Nine months ended September 30, 2015 | | | Nine months ended September 30, 2014 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Rate (4) | Average Balance | Interest | Yield/ Rate (4) |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) | $556,659 | $21,280 | 5.11 % | $509,252 | $19,795 | 5.20 % |
| Certificate of deposits | 12,121 | 66 | 0.73 % | 11,374 | 61 | 0.72 % |
| Interest bearing due from banks | 216,765 | 399 | 0.25 % | 191,428 | 350 | 0.24 % |
| Investment securities, taxable | 145,818 | 2,066 | 1.89 % | 155,383 | 2,232 | 1.92 % |
| Investment securities, non-taxable (2) | 7,578 | 198 | 3.49 % | 9,465 | 282 | 3.98 % |
| Other interest earning assets | 3,934 | 395 | 13.42% | 3,846 | 205 | 7.13 % |
| Total average interest-earning assets | 942,875 | 24,404 | 3.46 % | 880,748 | 22,925 | 3.48 % |
| Non-interest-earning assets: | | | | | | |
| Cash and due from banks | 21,605 | | | 16,662 | | |
| Premises and equipment, net | 7,172 | | | 7,402 | | |
| Other real estate owned | 232 | | | 211 | | |
| Interest receivable and other assets | 25,337 | | | 26,495 | | |
| Total average assets | 997,221 | | | 931,518 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing transaction deposits | 240,330 | 224 | 0.12 % | 215,690 | 223 | 0.14 % |
| Savings and MMDA's | 270,555 | 379 | 0.19 % | 255,533 | 467 | 0.24 % |
| Time, under $250,000 | 63,468 | 194 | 0.41 % | 67,203 | 201 | 0.40 % |
| Time, $250,000 and over | 20,704 | 60 | 0.39 % | 23,870 | 82 | 0.46 % |
| FHLB advances and other borrowings | 0 | - | 0.00 % | 2 | - | 0.00 % |
| Total average interest-bearing liabilities | 595,057 | 857 | 0.19 % | 562,298 | 973 | 0.23 % |
| Non-interest-bearing liabilities: | | | | | | |
| Non-interest-bearing demand deposits | 298,854 | | | 273,332 | | |
| Interest payable and other liabilities | 8,378 | | | 7,677 | | |
| Total liabilities | 902,289 | | | 843,307 | | |
| Total average stockholders' equity | 94,932 | | | 88,211 | | |
| Total average liabilities and stockholders' equity | $997,221 | | | $931,518 | | |
| Net interest income and net interest margin (3) | | $23,547 | 3.34 % | | $21,952 | 3.33 % |

(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 exculded. Loan interest income includes loan fees of approximately $951 and $706 for the nine months ended September 30, 2015 and 2014, respectively.
(2) Interest income and yields on tax-exempt securities are not presented on a taxable-equivalent basis.
(3) Net interest margin is computed by dividing net interest income by total average interest-earning assets.
(4) For disclosure purposes, yield /rates are annualized by dividing the number of days in the reported period by 365.

CHANGES IN FINANCIAL CONDITION

The assets of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect a $45,122,000 or 20.9% increase in cash and cash equivalents, a $16,644,000 or 11.0% decrease in investment securities available-for-sale, a $53,524,000 or 10.0% increase in net loans held-for-investment, a $923,000 or 7.2% decrease in certificate of deposits, a $736,000 or 100.0% decrease in other real estate owned and a $1,038,000 or 3.8% decrease in interest receivable and other assets from December 31, 2014 to September 30, 2015. The increase in cash and cash equivalents was primarily due to an increase in Federal Reserve Bank accounts and non-interesting bearing due from accounts, mainly due to deposit growth outpacing loan growth in the current period. The decrease in investment securities available-for-sale was primarily the result of sales of U.S. government agencies and payments on mortgage-backed securities and maturities and calls of U.S. government agencies and municipal securities, which was partially offset by the purchase of U.S. government agencies, municipal securities, and mortgage-backed securities. The increase in net loans held-for investment was primarily due to increased loan demand. The following loan categories had increases in the nine months ended September 30, 2015: commercial, commercial real estate, agriculture, and residential construction. The following loan categories had decreases in that period: residential mortgage and consumer. The decrease in other real estate owned was primarily due to the sale of three properties with an aggregate book value of $1,144,000. The decrease in interest receivable and other assets was mainly due to a decrease in other receivables.

The liabilities of the Company set forth in the Unaudited Condensed Consolidated Balance Sheets reflect an increase in total deposits of $74,296,000 from December 31, 2014 to September 30, 2015. The increase in deposits was due to increases in demand accounts, interest-bearing transaction deposits, savings accounts and money market accounts, which were 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 months ended September 30, 2015.

Interest income on loans for the nine months ended September 30, 2015 was up 7.5% from the same period in 2014, increasing from $19,795,000 to $21,280,000, and was up 11.4% for the three months ended September 30, 2015 over the same period in 2014, increasing from $6,717,000 to $7,480,000. The increase in interest income on loans for the nine months ended September 30, 2015 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 9 basis point decrease in loan yields. The increase in interest income on loans for the three months ended September 30, 2015 as compared to the same period a year ago was primarily due to an increase in average loans, partially offset by a 2 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 months ended September 30, 2015 was down 9.9% from the same period in 2014, decreasing from $2,514,000 to $2,264,000, and was down 15.4% for the three months ended September 30, 2015 over the same period in 2014, decreasing from $826,000 to $699,000. The decrease in interest income on investment securities for the three and nine months ended September 30, 2015 as compared to the same periods a year ago was primarily due to a decrease in average investment securities and a decrease in the yields on investment securities of 18 and 7 basis points, respectively.

Interest income on interest-bearing due from banks for the nine months ended September 30, 2015 was up 13.1% from the same period in 2014, increasing from $411,000 to $465,000, and was up 9.8% for the three months ended September 30, 2015 over the same period in 2014, increasing from $132,000 to $145,000. The increase in interest income on interest-bearing due from banks for the nine months ended September 30, 2015 as compared to the same period a year ago was due to an increase in the average interest-bearing due from banks and certificate of deposits balances outstanding, as well as a 1 basis point increase in certificate of deposits yield. The increase in interest income on interest-bearing due from banks for the three months ended September 30, 2015 as compared to the same period a year ago was due to an increase in the average interest-bearing due from banks and certificate of deposits balances outstanding, which was partially offset by a 3 basis point decrease in certificate of deposits yield.

The Company had no Federal Funds sold balances during the nine months ended September 30, 2015 and September 30, 2014.

Interest Expense

Interest expense on deposits and other borrowings for the nine months ended September 30, 2015 was down 11.9% from the same period in 2014, decreasing from $973,000 to $857,000, and was down 13.1% for the three months ended September 30, 2015 over the same period in 2014, decreasing from $312,000 to $271,000.  The decrease in interest expense during the three and nine months ended September 30, 2015 was primarily due to a 4 basis point decrease in the Company's average cost of funds, which was partially offset by an increase in the average balance of interest-bearing liabilities.  The Company had no FHLB advances and related interest expense during the nine months ended September 30, 2015 and September 30, 2014.

Provision for Loan Losses

There was a provision for loan losses of $650,000 for the nine months ended September 30, 2015 compared to a provision for loan losses of $1,600,000 for the same period in 2014.  There was a provision for loan losses of $300,000 for the three months ended September 30, 2015 compared to a provision for loan losses of $400,000 for the same period in 2014.  The allowance for loan losses was approximately $9,360,000, or 1.56% of total loans, at September 30, 2015, compared to $8,583,000, or 1.57% of total loans, at December 31, 2014.  The allowance for loan losses is maintained at a level considered adequate by management to provide for probable loan losses inherent in the loan portfolio.

The decrease in the provision for loan losses during the three and nine months ended September 2015 was primarily due to decreased net charge-offs and improved credit quality of the loan portfolio compared to the same periods in 2014.

Provision for Unfunded Lending Commitment Losses

There was no provision for unfunded lending commitment losses for the nine months ended September 30, 2015 and September 30, 2014.

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

Non-Interest Income

Non-Interest income was down 1.5% for the nine months ended September 30, 2015 from the same period in 2014, decreasing from $5,680,000 to $5,594,000.

This decrease was primarily due to decreases in service charges on deposit accounts, fiduciary activities income and other income, which was partially offset by increases in gains on sales of loans held-for-sale and loan servicing income. The decrease in service charges on deposit accounts was primarily due to a decrease in the volume of service charges on checking accounts. The decrease in fiduciary activities income was primarily due to a decrease in the demand for those services. The decrease in other income was primarily due to a decrease in gains on sales of equipment. The increase in gains on sales of loans held-for-sale was due to an increase in originations and sales of loans held-for-sale. The increase in loan servicing income was primarily due to an increase in mortgage servicing assets booked.

Non-Interest income was down 12.5% for the three months ended September 30, 2015 from the same period in 2014, decreasing from $2,104,000 to $1,841,000.

This decrease was primarily due to decreases in service charges on deposit accounts, debit card income and other income. The decrease in service charges on deposit accounts was primarily due to a decrease in the volume of service charges on checking accounts. The decrease in debit card income was primarily due to a decrease in volume of transactions. The decrease in other income was primarily due to a decrease in gains on sales of equipment.

Non-Interest Expenses

Total non-interest expenses were up 4.7% for the nine months ended September 30, 2015 from the same period in 2014, increasing from $19,745,000 to $20,680,000.

The increase was primarily due to increases in salaries and employee benefits and other expenses, which was partially offset by decreases in occupancy and equipment expense, other real estate owned expense and an increase in gains on sales of other real estate owned. The increase in salaries and employee benefits was primarily due to an increase in regular salaries, commissions, contingent compensation, and profit sharing. The increase in other expenses was primarily due to an increase in legal fees, which was partially offset by a decrease in loan collection expense. The decrease in occupancy and equipment expense was primarily due to a decrease in rent expense. The decrease in other real estate owned expense was due to a decrease in maintenance expense. The increase in gains on sales of other real estate owned was primarily due to an increase in the volume of other real estate owned sales transactions.

Total non-interest expenses were up 1.5% for the three months ended September 30, 2015 from the same period in 2014, increasing from $6,792,000 to $6,895,000.

The increase was primarily due to increases in salaries and employee benefits and other expenses, which was partially offset by decreases in other real estate owned expense and an increase in gains on sales of other real estate owned. The increase in salaries and employee benefits was primarily due to an increase in regular salaries, contingent compensation, and profit sharing. The increase in other expenses was primarily due to an increase in legal fees, which was partially offset by a decrease in loan collection expense. The decrease in other real estate owned expense was due to a decrease in maintenance expense. The increase in gains on sales of other real estate owned was primarily due to an increase in the volume of other real estate owned sales transactions.

The following table sets forth other non-interest expenses by category for the three and nine months ended September 30, 2015 and 2014.

| | (in thousands) Three months ended September 30, 2015 | Three months ended September 30, 2014 | Nine months ended September 30, 2015 | Nine months ended September 30, 2014 |
|---|---|---|---|---|
| Other non-interest expenses | | | | |
| FDIC assessments | $ 145 | $ 155 | $ 455 | $ 445 |
| Contributions | 47 | 34 | 111 | 96 |
| Legal fees | 134 | 34 | 368 | 106 |
| Accounting and audit fees | 95 | 73 | 242 | 249 |
| Consulting fees | 101 | 114 | 351 | 391 |
| Postage expense | 65 | 61 | 229 | 222 |
| Telephone expense | 34 | 35 | 98 | 105 |
| Public relations | 64 | 56 | 182 | 173 |
| Training expense | 49 | 44 | 134 | 107 |
| Loan origination expense | 154 | 169 | 490 | 428 |
| Computer software depreciation | 21 | 15 | 57 | 52 |
| Sundry losses | 70 | 34 | 171 | 114 |
| Loan collection expense | 15 | 76 | 62 | 223 |
| Other non-interest expense | 399 | 401 | 1,099 | 1,169 |
| Total other non-interest expenses | $ 1,393 | $ 1,301 | $ 4,049 | $ 3,880 |

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Income Taxes

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

In the nine months ended September 30, 2015, the Company's expense for income taxes increased $691,000 from the same period last year, from $2,014,000 to $2,705,000.

In the three months ended September 30, 2015, the Company's expense for income taxes increased $195,000 from the same period last year, from $782,000 to $977,000.

The increase in provision for income taxes for the period presented was 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, and excludable interest income.

Off-Balance Sheet Commitments

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

| | (in thousands) | |
|---|---|---|
| | September 30, 2015 | December 31, 2014 |
| Undisbursed loan commitments | $206,225 | $171,019 |
| Standby letters of credit | 2,972 | 2,099 |
| Commitments to sell loans | 2,137 | 1,230 |
| | $211,334 | $174,348 |

The reserve for unfunded lending commitments amounted to $793,000 at each of September 30, 2015 and December 31, 2014, respectively. The reserve for unfunded lending commitments is included in other liabilities on the Condensed 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 regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes:

Substandard Assets – A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets – An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable or improbable.

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

The following tables summarize the Company's non-accrual loans net of guarantees of the State of California and U.S. Government by loan category at September 30, 2015 and December 31, 2014:

| | At September 30, 2015 | | | At December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| (in thousands) | | | | | | |
| Commercial | $129 | $ 57 | $72 | $2,151 | $ 82 | $2,069 |
| Commercial real estate | 1,281 | 98 | 1,183 | 672 | - | 672 |
| Agriculture | - | - | - | - | - | - |
| Residential mortgage | 575 | - | 575 | 1,691 | - | 1,691 |
| Residential construction | 58 | - | 58 | 71 | - | 71 |
| Consumer | 563 | - | 563 | 652 | - | 652 |
| Total non-accrual loans | $2,606 | $ 155 | $2,451 | $5,237 | $ 82 | $5,155 |

It is generally the Company's policy to discontinue interest accruals once a loan is past due for a period of 90 days as to interest or principal payments. When a loan is placed on non-accrual, interest accruals cease and uncollected accrued interest is reversed and charged against current income. Payments received on non-accrual loans are applied against principal. A loan may only be restored to an accruing basis when it again becomes well secured and in the process of collection or all past due amounts have been collected.

Non-accrual loans amounted to $2,606,000 at September 30, 2015 and were comprised of four commercial loans totaling $129,000, five commercial real estate loans totaling $1,281,000, three residential mortgage loans totaling $575,000, one residential construction loan totaling $58,000 and four consumer loans totaling $563,000. Non-accrual loans amounted to $5,237,000 at December 31, 2014 and were comprised of six residential mortgage loans totaling $1,691,000, two residential construction loans totaling $71,000, five commercial real estate loans totaling $672,000, seven commercial loans totaling $2,151,000, and five consumer loans totaling $652,000. 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, 2015, totaled approximately $1,893,000, or 72.6% of total non-accrual loans, and consisted of one residential mortgage loan totaling $434,000, supported by residential properties located within the Company's market area, three commercial real estate loans totaling $1,031,000, supported by commercial properties located within the Company's market area, and one consumer loan totaling $428,000, supported by residential property located within the Company's market area. The collateral securing these loans is generally appraised every six months.

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In comparison, the five largest non-accrual loans as of December 31, 2014, totaled approximately $3,193,000, or 61.0% of total non-accrual loans, and consisted of two residential mortgage loans totaling $1,014,000, supported by residential property located within the Company's market area, two commercial and industrial loans totaling $1,756,000, supported by the business assets of the borrower, and one consumer loan totaling $423,000, supported by residential property located within the Company's market area. The collateral securing all of these loans is generally appraised every six months.

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, 2015 and December 31, 2014 consisted of loans on non-accrual status totaling $2,606,000 and $5,237,000, 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, which consisted of loans modified as troubled debt restructurings, totaled $5,480,000 and $5,467,000 at September 30, 2015 and December 31, 2014, respectively. The Company expects to collect all principal and interest due from performing impaired loans. These loans are not on non-accrual status. The majority of the non-performing impaired loans, in management's opinion, were adequately collateralized based on recently obtained appraised property values or were guaranteed by a governmental entity. See "Allowance for Loan Losses" below for additional information. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

As the following table illustrates, total non-performing assets, net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, decreased $3,440,000, or 58.4% to $2,451,000 during the first nine months of 2015. Non-performing assets, net of guarantees, represented 0.2% of total assets at September 30, 2015.

| | At September 30, 2015 | | | At December 31, 2014 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Gross | Guaranteed | Net | Gross | Guaranteed | Net |
| Non-accrual loans | $2,606 | $ 155 | $2,451 | $5,237 | $ 82 | $5,155 |
| Loans 90 days past due and still accruing | - | - | - | - | - | - |
| Total non-performing loans | 2,606 | 155 | 2,451 | 5,237 | 82 | 5,155 |
| Other real estate owned | - | - | - | 736 | - | 736 |
| Total non-performing assets | $2,606 | $ 155 | $2,451 | $5,973 | $ 82 | $5,891 |
| Non-performing loans to total loans | | | 0.4 % | | | 0.9 % |
| Non-performing assets to total assets | | | 0.2 % | | | 0.6 % |
| Allowance for loan and lease losses to non-performing loans (net of guarantees) | | | 381.9% | | | 166.5% |

The Company had no loans 90 days or more past due and still accruing at September 30, 2015 and December 31, 2014.

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 $736,000 as of September 30, 2015 and December 31, 2014, 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 non-interest expense and reduced by net charge-offs. The Company contracts with vendors for credit reviews of the loan portfolio as well as considers current economic conditions, loan loss experience, and other factors in determining the adequacy of the reserve balance. The allowance for loan losses is based on estimates, and actual losses may vary from current estimates.

The following table summarizes the Allowance for Loan Losses of the Company during the nine months ended September 30, 2015 and 2014, and for the year ended December 31, 2014:

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

| | Nine months ended September 30, | | Year ended December 31, |
|---|---|---|---|
| | 2015 | 2014 | 2014 |
| Balance at beginning of period | $8,583 | $9,353 | $ 9,353 |
| Provision for loan losses | 650 | 1,600 | 1,800 |
| Loans charged-off: | | | |
| Commercial | (14 ) | (2,288) | (2,288 ) |
| Commercial Real Estate | - | (69 ) | (69 ) |
| Agriculture | - | - | - |
| Residential Mortgage | (132 ) | - | (71 ) |
| Residential Construction | - | - | - |
| Consumer | (152 ) | (378 ) | (393 ) |
| Total charged-off | (298 ) | (2,735) | (2,821 ) |
| Recoveries: | | | |
| Commercial | 90 | 46 | 58 |
| Commercial Real Estate | 17 | - | - |
| Agriculture | - | - | - |
| Residential Mortgage | 216 | - | - |
| Residential Construction | 58 | 45 | 86 |
| Consumer | 44 | 93 | 107 |
| Total recoveries | 425 | 184 | 251 |
| Net recoveries (charge-offs) | 127 | (2,551) | (2,570 ) |
| Balance at end of period | $9,360 | $8,402 | $ 8,583 |
| Ratio of net charge-offs to average loans outstanding during the period (annualized) | 0.03 % | -0.66 % | -0.49 % |
| Allowance for loan losses To total loans at the end of the period | 1.56 % | 1.58 % | 1.57 % |

| | | | |
|---|---|---|---|
| To non-performing loans, net of guarantees at the end of the period | 381.9% | 130.4 % | 166.5 % |

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Deposits

Deposits are one of the Company's primary sources of funds. At September 30, 2015, the Company had the following deposit mix: 30.7% in savings and MMDA deposits, 8.9% in time deposits, 26.4% in interest-bearing transaction deposits and 34.0% in non-interest-bearing transaction deposits. At December 31, 2014, the Company had the following deposit mix: 30.8% in savings and MMDA deposits, 10.0% in time deposits, 25.6% in interest-bearing transaction deposits and 33.6% 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 $250,000 from customers. These deposits are priced to remain competitive.

Maturities of time certificates of deposits of $250,000 or more outstanding at September 30, 2015 and December 31, 2014 are summarized as follows:

| | (in thousands) | |
|---|---|---|
| | September 30, 2015 | December 31, 2014 |
| Three months or less | $6,954 | $ 8,369 |
| Over three to twelve months | 8,817 | 9,598 |
| Over twelve months | 4,658 | 2,636 |
| Total | $20,429 | $ 20,603 |

The decrease in time certificates of deposit (CD's) of $250,000 or more was primarily attributable to maturities of time deposits, which was partially offset by the additions 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 63.6% on September 30, 2015. In addition, on September 30, 2015, the Company had the following short-term investments (based on remaining maturity and/or next repricing date): $1,126,000 in securities due within one year or less; and $26,757,000 in securities due in one to five years.

To meet unanticipated funding requirements, the Company maintains short-term unsecured lines of credit with other banks which totaled $57,000,000 at September 30, 2015. Additionally, the Company has a line of credit with the FHLB, with a borrowing capacity at September 30, 2015 of $237,234,000; 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, 2015, 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, 2015.

(amounts in thousands except percentage amounts)
Actual

| | Capital | Ratio | Well Capitalized Ratio Requirement |
|---|---|---|---|
| Leverage | $93,244 | 9.20 % | 5.0 % |
| Common Equity Tier 1 | $93,244 | 13.95% | 6.5 % |
| Tier 1 Risk-Based | $93,244 | 13.95% | 8.0 % |
| Total Risk-Based | $101,621 | 15.20% | 10.0 % |

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

The Company believes that there have been no material changes in the quantitative and qualitative disclosures about market risk as of September 30, 2015, from those presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014, 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, 2015. This conclusion is based on an evaluation conducted under the supervision and with the participation of management.

(b) During the quarter ended September 30, 2015, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. – LEGAL PROCEEDINGS

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

ITEM 1A. – RISK FACTORS

For a discussion of risk factors relating to our business, please refer to Part I, Item 1A of our 2014 Form 10-K, which is incorporated by reference herein, and to the following:

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

At September 30, 2015, approximately 73% in principal amount of the Bank's loans (excluding loans held-for-sale) were secured by real estate. The value of the Bank's real estate collateral has been, and could in the future continue to be, adversely affected by the economic recession and resulting adverse impact on the real estate market in Northern California.

The Bank's primary lending focus has historically been commercial (including agricultural), construction, and real estate mortgage. At September 30, 2015, real estate mortgage (excluding loans held-for-sale) and construction loans (residential and other) comprised approximately 71% and 2%, respectively, in principal amount of the total loans in the Bank's portfolio. At September 30, 2015, all of the Bank's real estate mortgage and construction loans and approximately 8% in principal amount of its commercial loans were secured fully or in part by deeds of trust on underlying real estate. The Company's dependence on real estate increases the risk of loss in both the Bank's loan portfolio and its holdings of other real estate owned if economic conditions in Northern California further deteriorate in the future. Further deterioration of the real estate market in Northern California would have a material adverse effect on the Company's business, financial condition, and results of operations.

The CFPB has adopted various regulations which have and will continue to impact our residential mortgage lending business. For additional information, see "Business – Certain CFPB Rules" in Part I, Item 1 in our Annual Report on Form 10-K.

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

The Bank's operations and a substantial majority of the Bank's assets and deposits are generated and concentrated primarily in Northern California, particularly the counties of Placer, Sacramento, Solano and Yolo, and are likely to remain so for the foreseeable future. At September 30, 2015, approximately 73% in principal amount of the Bank's loan portfolio (excluding loans held-for-sale) consisted of real estate-related loans, all of which were secured by collateral located in Northern California. As a result, a further downturn in the economic conditions in Northern California may cause the Bank to incur losses associated with high default rates and decreased collateral values in its loan portfolio. Economic conditions in California are subject to various uncertainties at this time, including the significant deterioration in the California real estate market and housing industry.

For the last several years, economic conditions in California, and especially the regional markets we serve, have been subject to various challenges, including significant deterioration in the residential real estate sector and the California state government's budgetary and fiscal difficulties. California continues to have a high unemployment rate. Also, California markets have experienced some of the worst property value declines in the U.S.

In addition, in the recent past, the State government of California has experienced budget shortfalls or deficits that have led to protracted negotiations between the Governor and the State Legislature over how to address the budget gap. The California electorate approved, in the November 2012 general elections, certain increases in the rate of income taxation in California, and also elected Democratic super-majorities in both Houses of the California legislature, thus potentially facilitating further increases in California tax rates. As a consequence, California's current budget does not reflect a deficit, however, there can be no assurance that the state's fiscal and budgetary challenges will be readily resolved. In addition, the impact of increased rates of income taxation on the level of economic activity in California cannot be predicted at this time.

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

Poor economic conditions in California, and especially the regional markets we serve, will cause us to incur losses associated with higher default rates and decreased collateral values in our loan portfolio. If the budgetary and fiscal difficulties of the California State government and California municipalities and other governmental units continue or economic conditions in California decline further, we expect that our level of problem assets will increase and our prospects for growth will be impaired. The severe drought which California has experienced in recent years, if it continues, may also cause further difficulties for the California economy, particularly in the agricultural sector. In April 2015, California Governor, Edmund G. Brown, Jr., issued an executive order directing the State Water Resource Control Board to implement mandatory water reductions in cities and towns across California to reduce water usage by 25%. The impact of this and other measures in response to the drought on the California business climate and economy cannot be predicted.

Information Security Breaches or Other Technological Difficulties Could Adversely Affect the Company

Our operations rely on the secure processing, storage, transmission and reporting of personal, confidential and other sensitive information in our computer systems, networks and business applications. Although we take protective measures, our computer systems may be vulnerable to breaches, unauthorized access, misuse, computer viruses or other malicious code, and other events that could have significant negative consequences to us. Such events could

result in interruptions or malfunctions in our or our customers' operations, interception, misuse or mishandling of personal or confidential information, or processing of unauthorized transactions or loss of funds. These events could result in litigation and financial losses that are either not insured against or not fully covered by our insurance, regulatory consequences or reputational harm, any of which could harm our competitive position, operating results and financial condition. These types of incidents can remain undetected for extended periods of time, thereby increasing the associated risks. We may also be required to expend significant resources to modify our protective measures or to investigate and remediate vulnerabilities or exposures arising from cybersecurity risks.

We depend on the continued efficacy of our technical systems, operational infrastructure, relationships with third parties and our employees in our day-to-day and ongoing operations. Our dependence upon automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. With regard to the physical infrastructure that supports our operations, we have taken measures to implement backup systems and other safeguards, but our ability to conduct business may be adversely affected by any disruption to that infrastructure. Failures in our internal control or operational systems, security breaches or service interruptions could impair our ability to operate our business and result in potential liability to customers, reputational damage and regulatory intervention, any of which could harm our operating results and financial condition.

We may also be subject to disruptions of our operating systems arising from other events that are wholly or partially beyond our control, such as electrical, internet or telecommunications outages, natural disasters (such as major seismic events), or unexpected difficulties with the implementation of our technology enhancement projects, which may give rise to disruption of service to customers and to financial loss or liability. Our business recovery plan may not work as intended or may not prevent significant interruptions of our operations.

In recent years, it has been reported that several of the larger U.S. banking institutions have been the target of cyberattacks that have, for limited periods, resulted in the disruption of various operations of the targeted banks. While we have a variety of cyber-security measures in place, the consequences to our business, if we were to become a target of such attacks, cannot be predicted with any certainty.

In addition, there have been increasing efforts on the part of third parties to breach data security at financial institutions or with respect to financial transactions, including through the use of social engineering schemes such as "phishing." The ability of our customers to bank remotely, including online and though mobile devices, requires secure transmission of confidential information and increases the risk of data security breaches.

Even if cyber-attacks and similar tactics are not directed specifically at the Bank, such attacks on other large financial institutions could disrupt the overall functioning of the financial system and undermine consumer confidence in banks generally, to the detriment of other financial institutions, including the Bank. A data security breach at a large U.S. retailer recently resulted in the compromise of data related to credit and debit cards of large numbers of customers requiring many banks, including the Bank, to reissue credit and debit cards for affected customers and reimburse these customers for losses sustained.

In March of 2015, the Federal bank regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes that enable recovery of data and business operations and that address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. While we do not believe that these statements contain any new regulatory expectations, we are continuing to evaluate them and they do indicate that the regulators regard cybersecurity to be a matter of great importance for U.S. financial institutions. A financial institution which fails to observe the regulatory guidance could be subject to various regulatory sanctions, including financial penalties.

In July of 2015, the Federal bank regulators announced the issuance of a cybersecurity assessment tool, the output of which can assist a financial institution's senior management and board of directors in assessing the institution's cybersecurity risk and preparedness. The first part of the assessment tool is the inherent risk profile, which aims to assist management in determining an institution's level of cybersecurity risk. The second part of the assessment tool is

cybersecurity maturity, which is designed to help management assess whether their controls provide the desired level of preparedness. Beginning in late 2015 or early 2016, the Federal bank regulators plan to utilize the assessment tool as part of their examination process when evaluating financial institutions' cybersecurity preparedness in information technology and safety and soundness examinations and inspections. We are evaluating this newly issued assessment tool, as well as the resources which will be necessary to effectively utilize the assessment tool and meet regulatory expectations.



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

None.

ITEM 3. – DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. – MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. – OTHER INFORMATION

None.

ITEM 6. – EXHIBITS

| Exhibit 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, 2015, 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 5, 2015 By: /s/ Jeremiah Z. Smith

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