

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
November 14, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2016**

or

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

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

Commission File Number: **001-34527**

**EMCLAIRE FINANCIAL CORP**

(Exact name of registrant as specified in its charter)

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Pennsylvania 25-1606091  
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

612 Main Street, Emlenton, Pennsylvania 16373  
(Address of principal executive offices) (Zip Code)

**(844) 767-2311**  
(Registrant's telephone number)

N/A  
(Former name, former address and former fiscal year, if changed since last report)

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  No

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The number of shares outstanding of the Registrant's common stock was 2,146,308 at November 14, 2016.

**EMCLAIRE FINANCIAL CORP**

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**PART I - FINANCIAL INFORMATION****Item 1. Interim Financial Statements**

Emclaire Financial Corp

Consolidated Balance Sheets (Unaudited)

As of September 30, 2016 and December 31, 2015

(Dollar amounts in thousands, except share and per share data)

|                                                                           | September<br>30,<br>2016 | December<br>31,<br>2015 |
|---------------------------------------------------------------------------|--------------------------|-------------------------|
| Assets                                                                    |                          |                         |
| Cash and due from banks                                                   | \$ 2,532                 | \$ 2,359                |
| Interest earning deposits with banks                                      | 24,272                   | 9,187                   |
| Cash and cash equivalents                                                 | 26,804                   | 11,546                  |
| Securities available for sale                                             | 102,463                  | 112,981                 |
| Loans held for sale                                                       | 58                       | -                       |
| Loans receivable, net of allowance for loan losses of \$5,514 and \$5,205 | 508,183                  | 429,891                 |
| Federal bank stocks, at cost                                              | 3,854                    | 4,240                   |
| Bank-owned life insurance                                                 | 11,304                   | 11,056                  |
| Accrued interest receivable                                               | 1,969                    | 1,501                   |
| Premises and equipment, net                                               | 18,382                   | 16,114                  |
| Goodwill                                                                  | 10,291                   | 3,664                   |
| Core deposit intangible, net                                              | 621                      | 554                     |
| Prepaid expenses and other assets                                         | 9,743                    | 9,048                   |
| Total Assets                                                              | \$ 693,672               | \$ 600,595              |
| Liabilities and Stockholders' Equity                                      |                          |                         |
| Liabilities:                                                              |                          |                         |
| Deposits:                                                                 |                          |                         |
| Non-interest bearing                                                      | \$ 124,144               | \$ 119,790              |
| Interest bearing                                                          | 468,456                  | 370,097                 |
| Total deposits                                                            | 592,600                  | 489,887                 |
| Short-term borrowed funds                                                 | 2,500                    | 14,250                  |

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|                                                                                                                                                               |                   |                   |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Long-term borrowed funds                                                                                                                                      | 34,750            | 35,000            |
| Accrued interest payable                                                                                                                                      | 236               | 179               |
| Accrued expenses and other liabilities                                                                                                                        | 8,370             | 8,440             |
| <b>Total Liabilities</b>                                                                                                                                      | <b>638,456</b>    | <b>547,756</b>    |
| <b>Commitments and Contingent Liabilities</b>                                                                                                                 | <b>-</b>          | <b>-</b>          |
| <b>Stockholders' Equity:</b>                                                                                                                                  |                   |                   |
| Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,248,325 and 2,246,825 shares issued; 2,146,308 and 2,144,808 shares outstanding, respectively | 2,810             | 2,808             |
| Additional paid-in capital                                                                                                                                    | 27,853            | 27,701            |
| Treasury stock, at cost; 102,017 shares                                                                                                                       | (2,114 )          | (2,114 )          |
| Retained earnings                                                                                                                                             | 29,322            | 28,206            |
| Accumulated other comprehensive loss                                                                                                                          | (2,655 )          | (3,762 )          |
| <b>Total Stockholders' Equity</b>                                                                                                                             | <b>55,216</b>     | <b>52,839</b>     |
| <b>Total Liabilities and Stockholders' Equity</b>                                                                                                             | <b>\$ 693,672</b> | <b>\$ 600,595</b> |

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Net Income (Unaudited)

For the three and nine months ended September 30, 2016 and 2015

(Dollar amounts in thousands, except share and per share data)

|                                                     | For the three months ended<br>September 30, |          | For the nine months ended<br>September 30, |           |
|-----------------------------------------------------|---------------------------------------------|----------|--------------------------------------------|-----------|
|                                                     | 2016                                        | 2015     | 2016                                       | 2015      |
| Interest and dividend income:                       |                                             |          |                                            |           |
| Loans receivable, including fees                    | \$ 5,444                                    | \$ 4,382 | \$ 15,331                                  | \$ 13,051 |
| Securities:                                         |                                             |          |                                            |           |
| Taxable                                             | 396                                         | 481      | 1,270                                      | 1,525     |
| Exempt from federal income tax                      | 157                                         | 205      | 473                                        | 640       |
| Federal bank stocks                                 | 49                                          | 30       | 135                                        | 132       |
| Interest earning deposits with banks                | 48                                          | 15       | 110                                        | 50        |
| Total interest and dividend income                  | 6,094                                       | 5,113    | 17,319                                     | 15,398    |
| Interest expense:                                   |                                             |          |                                            |           |
| Deposits                                            | 781                                         | 532      | 2,091                                      | 1,613     |
| Borrowed funds                                      | 308                                         | 155      | 847                                        | 514       |
| Total interest expense                              | 1,089                                       | 687      | 2,938                                      | 2,127     |
| Net interest income                                 | 5,005                                       | 4,426    | 14,381                                     | 13,271    |
| Provision for (recovery of) loan losses             | 168                                         | (102 )   | 470                                        | 269       |
| Net interest income after provision for loan losses | 4,837                                       | 4,528    | 13,911                                     | 13,002    |
| Noninterest income:                                 |                                             |          |                                            |           |
| Fees and service charges                            | 433                                         | 387      | 1,164                                      | 1,113     |
| Commissions on financial services                   | 1                                           | 14       | 2                                          | 24        |
| Title premiums                                      | 10                                          | 13       | 29                                         | 29        |
| Net gain on sales of available for sale securities  | -                                           | 533      | 83                                         | 567       |
| Net gain on sales of loans                          | 121                                         | -        | 121                                        | -         |
| Earnings on bank-owned life insurance               | 101                                         | 98       | 299                                        | 293       |
| Other                                               | 346                                         | 334      | 1,036                                      | 980       |
| Total noninterest income                            | 1,012                                       | 1,379    | 2,734                                      | 3,006     |
| Noninterest expense:                                |                                             |          |                                            |           |
| Compensation and employee benefits                  | 2,259                                       | 2,003    | 6,484                                      | 6,122     |
| Premises and equipment                              | 732                                         | 646      | 2,110                                      | 1,970     |
| Intangible asset amortization                       | 60                                          | 49       | 165                                        | 146       |

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|                                             |           |           |           |           |
|---------------------------------------------|-----------|-----------|-----------|-----------|
| Professional fees                           | 172       | 181       | 545       | 560       |
| Federal deposit insurance                   | 123       | 92        | 305       | 287       |
| Acquisition costs                           | -         | -         | 401       | -         |
| Other                                       | 1,148     | 956       | 2,965     | 2,817     |
| Total noninterest expense                   | 4,494     | 3,927     | 12,975    | 11,902    |
| Income before provision for income taxes    | 1,355     | 1,980     | 3,670     | 4,106     |
| Provision for income taxes                  | 297       | 460       | 880       | 877       |
| Net income                                  | 1,058     | 1,520     | 2,790     | 3,229     |
| Preferred stock dividends                   | -         | 25        | -         | 75        |
| Net income available to common stockholders | \$ 1,058  | \$ 1,495  | \$ 2,790  | \$ 3,154  |
| Basic earnings per common share             | \$ 0.49   | \$ 0.70   | \$ 1.30   | \$ 1.64   |
| Diluted earnings per common share           | 0.49      | 0.70      | 1.29      | 1.63      |
| Average common shares outstanding - basic   | 2,146,308 | 2,136,749 | 2,145,761 | 1,928,789 |
| Average common shares outstanding - diluted | 2,158,273 | 2,148,713 | 2,155,902 | 1,939,708 |

See accompanying notes to consolidated financial statements.



**Emclaire Financial Corp**

## Consolidated Statements of Comprehensive Income (Unaudited)

For the three and nine months ended September 30, 2016 and 2015

(Dollar amounts in thousands)

|                                                              | For the three months ended<br>September 30, |          | For the nine months ended<br>September 30, |          |
|--------------------------------------------------------------|---------------------------------------------|----------|--------------------------------------------|----------|
|                                                              | 2016                                        | 2015     | 2016                                       | 2015     |
| Net income                                                   | \$ 1,058                                    | \$ 1,520 | \$ 2,790                                   | \$ 3,229 |
| Other comprehensive income (loss)                            |                                             |          |                                            |          |
| Unrealized gains/(losses) on securities:                     |                                             |          |                                            |          |
| Unrealized holding gain/(loss) arising during the period     | (271 )                                      | 1,200    | 1,760                                      | 982      |
| Reclassification adjustment for gains included in net income | -                                           | (533 )   | (83 )                                      | (567 )   |
|                                                              | (271 )                                      | 667      | 1,677                                      | 415      |
| Tax effect                                                   | 92                                          | (227 )   | (570 )                                     | (141 )   |
| Net of tax                                                   | (179 )                                      | 440      | 1,107                                      | 274      |
| Comprehensive income                                         | \$ 879                                      | \$ 1,960 | \$ 3,897                                   | \$ 3,503 |

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

## Condensed Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended September 30, 2016 and 2015

(Dollar amounts in thousands)

|                                                                                   | For the nine months ended<br>September 30,<br>2016 | 2015     |
|-----------------------------------------------------------------------------------|----------------------------------------------------|----------|
| Cash flows from operating activities                                              |                                                    |          |
| Net income                                                                        | \$ 2,790                                           | \$ 3,229 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                                    |          |
| Depreciation and amortization                                                     | 835                                                | 751      |
| Provision for loan losses                                                         | 470                                                | 269      |
| Amortization of premiums, net                                                     | 300                                                | 246      |
| Amortization of intangible assets and mortgage servicing rights                   | 179                                                | 146      |
| Realized gains on sales of available for sale securities, net                     | (83 )                                              | (567 )   |
| Net gains on sales of loans                                                       | (121 )                                             | -        |
| Net gains on foreclosed real estate                                               | (17 )                                              | (25 )    |
| Loss on sale of premises and equipment                                            | 10                                                 | -        |
| Loans originated for sale                                                         | (1,101 )                                           | -        |
| Proceeds from the sale of loans originated for sale                               | 1,078                                              | -        |

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|                                                                                     |          |           |
|-------------------------------------------------------------------------------------|----------|-----------|
| Write-down of foreclosed real estate                                                | -        | 6         |
| Stock compensation expense                                                          | 154      | 150       |
| Increase in bank-owned life insurance, net                                          | (248 )   | (245 )    |
| Increase in accrued interest receivable                                             | (234 )   | (52 )     |
| Increase in prepaid expenses and other assets                                       | (271 )   | (2,504 )  |
| Increase (decrease) in accrued interest payable                                     | 28       | (13 )     |
| Decrease in accrued expenses and other liabilities                                  | (465 )   | (124 )    |
| Net cash provided by operating activities                                           | 3,304    | 1,267     |
| Cash flows from investing activities                                                |          |           |
| Loan originations and principal collections, net                                    | (8,071 ) | (3,764 )  |
| Purchase of residential mortgage loans                                              | (6,911 ) | (19,481 ) |
| Proceeds from sales of loans held for sale previously classified as portfolio loans | 1,944    | -         |
| Settlement of syndicated national credits                                           | -        | (7,039 )  |
| Available for sale securities:                                                      |          |           |
| Sales                                                                               | 6,118    | 30,691    |
| Maturities, repayments and calls                                                    | 15,478   | 19,382    |
| Purchases                                                                           | (9,270 ) | (20,540 ) |
| Net cash paid for acquisition                                                       | (3,309 ) | -         |
| Redemption of federal bank stocks                                                   | 1,364    | 224       |
| Proceeds from the sale of foreclosed real estate                                    | 215      | 317       |
| Purchases of premises and                                                           | (1,943 ) | (649 )    |

|                                                                |           |   |           |   |
|----------------------------------------------------------------|-----------|---|-----------|---|
| equipment                                                      |           |   |           |   |
| Net cash used in investing activities                          | (4,385    | ) | (859      | ) |
| Cash flows from financing activities                           |           |   |           |   |
| Net increase in deposits                                       | 30,013    |   | 3,340     |   |
| Repayments on long-term debt                                   | (5,250    | ) | -         |   |
| Proceeds from other long-term debt                             | 5,000     |   | -         |   |
| Net change in short-term borrowings                            | (11,750   | ) | (5,100    | ) |
| Proceeds from exercise of stock options, including tax benefit | -         |   | 54        |   |
| Dividends paid                                                 | (1,674    | ) | (1,444    | ) |
| Proceeds from the issuance of common stock                     | -         |   | 8,151     |   |
| Redemption of preferred stock (Series B)                       | -         |   | (5,000    | ) |
| Net cash provided by financing activities                      | 16,339    |   | 1         |   |
| Increase in cash and cash equivalents                          | 15,258    |   | 409       |   |
| Cash and cash equivalents at beginning of period               | 11,546    |   | 11,856    |   |
| Cash and cash equivalents at end of period                     | \$ 26,804 |   | \$ 12,265 |   |
| Supplemental information:                                      |           |   |           |   |
| Interest paid                                                  | \$ 2,881  |   | \$ 2,140  |   |
| Income taxes paid                                              | 600       |   | 525       |   |
| Supplemental noncash disclosure:                               |           |   |           |   |
| Transfers from loans to foreclosed real estate                 | 218       |   | 341       |   |
| Transfers from portfolio loans to loans held for sale          | 1,859     |   | -         |   |

See accompanying notes to consolidated financial statements.

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## Emclaire Financial Corp

## Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

For the three and nine months ended September 30, 2016 and 2015

(Dollar amounts in thousands, except per share data)

|                                                        | For the three months ended<br>September 30, |           | For the nine months ended<br>September 30, |           |
|--------------------------------------------------------|---------------------------------------------|-----------|--------------------------------------------|-----------|
|                                                        | 2016                                        | 2015      | 2016                                       | 2015      |
| Balance at beginning of period                         | \$ 54,851                                   | \$ 56,901 | \$ 52,839                                  | \$ 47,990 |
| Net income                                             | 1,058                                       | 1,520     | 2,790                                      | 3,229     |
| Other comprehensive income (loss)                      | (179 )                                      | 440       | 1,107                                      | 274       |
| Stock compensation expense                             | 44                                          | 42        | 154                                        | 150       |
| Dividends declared on preferred stock                  | -                                           | (25 )     | -                                          | (75 )     |
| Dividends declared on common stock                     | (558 )                                      | (513 )    | (1,674 )                                   | (1,369 )  |
| Exercise of stock options, including tax benefit       | -                                           | 50        | -                                          | 54        |
| Issuance of common stock (350,000 shares)              | -                                           | (11 )     | -                                          | 8,151     |
| Redemption of preferred stock (5,000 shares, Series B) | -                                           | (5,000 )  | -                                          | (5,000 )  |
| Balance at end of period                               | \$ 55,216                                   | \$ 53,404 | \$ 55,216                                  | \$ 53,404 |
| Cash dividend per common share                         | \$ 0.26                                     | \$ 0.24   | \$ 0.78                                    | \$ 0.72   |

See accompanying notes to consolidated financial statements.

## **Emclair Financial Corp**

Notes to Consolidated Financial Statements (Unaudited)

### **1. Nature of Operations and Basis of Presentation**

Emclair Financial Corp (the Corporation) is a Pennsylvania corporation and the holding company of The Farmers National Bank of Emlenton (the Bank) and Emclair Settlement Services, LLC (the Title Company). The Corporation provides a variety of financial services to individuals and businesses through its offices in Western Pennsylvania. Its primary deposit products are checking, savings and term certificate accounts and its primary lending products are residential and commercial mortgages, commercial business loans and consumer loans.

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, the Bank and the Title Company. All significant intercompany transactions and balances have been eliminated in preparing the consolidated financial statements.

The accompanying unaudited consolidated financial statements for the interim periods include all adjustments, consisting of normal recurring accruals, which are necessary, in the opinion of management, to fairly reflect the Corporation's consolidated financial position and results of operations. Additionally, these consolidated financial statements for the interim periods have been prepared in accordance with instructions for the Securities and Exchange Commission's (SEC's) Form 10-Q and Article 10 of Regulation S-X and therefore do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). For further information, refer to the audited consolidated financial statements and footnotes thereto for the year ended December 31, 2015, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC.

The balance sheet at December 31, 2015 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements.

The preparation of financial statements, in conformity with GAAP, requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The results of operations for interim quarterly or year-to-date periods are not necessarily indicative of the results that may be expected for the entire year or any other period. Certain amounts previously reported may have been reclassified to conform to the current year's financial statement presentation.

**2. Mergers and Acquisitions**

On April 30, 2016, the Corporation completed its acquisition of United American Savings Bank (United American) in accordance with the terms of the Agreement and Plan of Merger, dated as of December 30, 2015, by and among the Corporation, the Bank and United American (the Merger Agreement). Pursuant to the Merger Agreement, the Corporation acquired United American through a reverse merger of a newly created, wholly-owned subsidiary of the Bank into United American. Immediately after the merger, United American merged with and into The Farmers National Bank of Emlenton, with The Farmers National Bank of Emlenton being the surviving bank. At December 31, 2015, United American had reported assets of \$89.3 million. The Corporation acquired all of the outstanding shares of common stock of United American for cash consideration of \$13.2 million (\$42.67 per share).

The acquisition expanded the Corporation's franchise into contiguous markets and increased the Corporation's consolidated total assets, loans and deposits.

The assets and liabilities of United American were recorded on the Corporation's consolidated balance sheet at their estimated fair value as of April 30, 2016, and their results of operations have been included in the consolidated income statement since such date.



## 2. Mergers and Acquisitions (continued)

Included in the purchase price was goodwill and a core deposit intangible of \$6.6 million and \$232,000, respectively. Goodwill is the excess of the purchase price over the fair value of the identifiable net assets acquired and is the result of expected operational synergies and other factors. This goodwill is not expected to be deductible for tax purposes. The goodwill will not be amortized, but will be measured annually for impairment or more frequently if circumstances require. The core deposit intangible will be amortized over a weighted average estimated life of ten years using the double declining balance method. Core deposit intangible expense projected for the succeeding five years beginning 2016 is estimated to be \$31,000, \$40,000, \$32,000, \$26,000 and \$20,000 per year, respectively, and \$83,000 in total for years after 2020.

While the Corporation believes that the accounting for the acquisition is complete, accounting guidance allows for adjustments to goodwill for a period of up to one year after the acquisition date for information that becomes available that reflects circumstances at the acquisition date. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed:

(Dollar amounts in thousands)

|                                        |          |
|----------------------------------------|----------|
| Assets acquired:                       |          |
| Cash and cash equivalents              | \$9,899  |
| Securities available for sale          | 60       |
| Loans receivable                       | 66,145   |
| Federal bank stocks                    | 978      |
| Accrued interest receivable            | 234      |
| Premises and equipment                 | 1,169    |
| Goodwill                               | 6,626    |
| Core deposit intangible                | 232      |
| Prepaid expenses and other assets      | 989      |
| Total assets acquired                  | 86,332   |
| Liabilities assumed:                   |          |
| Deposits                               | 72,700   |
| Accrued interest payable               | 29       |
| Accrued expenses and other liabilities | 395      |
| Total liabilities assumed              | 73,124   |
| Consideration paid                     | \$13,208 |

The fair value of loans was determined using discounted cash flows. The book balance of the loans at the time of the acquisition was \$66.1 million before considering United American's allowance for loan losses, which was not carried over. The fair value disclosed above reflects a credit-related adjustment of \$(927,000) and an adjustment for other

factors of \$982,000. Loans evidencing credit deterioration since origination (purchased credit impaired loans) included in loans receivable were immaterial.

For the nine months ended September 30, 2016, costs related to the acquisition totaled \$401,000 including legal fees, system conversion costs and other costs of \$194,000, \$132,000 and \$75,000, respectively.

### **3. Issuance of Common Stock**

On June 10, 2015, the Corporation sold 350,000 shares of common stock, par value of \$1.25 per share, in a private offering to accredited individual and institutional investors at \$23.50 per share. The Corporation realized \$8.2 million in proceeds from the offering, net of \$63,000 of direct costs relating to the offering.

**4. Participation in the Small Business Lending Fund (SBLF) of the U.S. Treasury Department (U.S. Treasury)**

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$10.0 million, pursuant to the U.S. Treasury's SBLF program. On September 17, 2013, with the approval of the Corporation's primary federal banking regulator, the Corporation redeemed 5,000 shares, or 50%, of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of \$5.0 million, plus accrued but unpaid dividends. On September 30, 2015, the Corporation redeemed the remaining 5,000 shares of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of \$5.0 million, plus accrued but unpaid dividends. Following this redemption, the Corporation does not have any Series B Preferred Stock outstanding.

**5. Earnings per Common Share**

Basic earnings per common share (EPS) excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS includes the dilutive effect of additional potential common shares for assumed issuance of restricted stock and shares issued under stock options.

The factors used in the Corporation's earnings per common share computation follow:

| (Dollar amounts in thousands, except for per share amounts) | For the three months ended |                    | For the nine months ended |                    |
|-------------------------------------------------------------|----------------------------|--------------------|---------------------------|--------------------|
|                                                             | September 30, 2016         | September 30, 2015 | September 30, 2016        | September 30, 2015 |
| Earnings per common share - basic                           |                            |                    |                           |                    |
| Net income                                                  | \$ 1,058                   | \$ 1,520           | \$ 2,790                  | \$ 3,229           |
| Less: Preferred stock dividends                             | -                          | 25                 | -                         | 75                 |
| Net income available to common stockholders                 | \$ 1,058                   | \$ 1,495           | \$ 2,790                  | \$ 3,154           |
| Average common shares outstanding                           | 2,146,308                  | 2,136,749          | 2,145,761                 | 1,928,789          |
| Basic earnings per common share                             | \$0.49                     | \$0.70             | \$1.30                    | \$1.64             |
| Earnings per common share - diluted                         |                            |                    |                           |                    |

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|                                                                                             |           |           |           |           |
|---------------------------------------------------------------------------------------------|-----------|-----------|-----------|-----------|
| Net income available to common stockholders                                                 | \$ 1,058  | \$ 1,495  | \$ 2,790  | \$ 3,154  |
| Average common shares outstanding                                                           | 2,146,308 | 2,136,749 | 2,145,761 | 1,928,789 |
| Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options | 11,965    | 11,964    | 10,141    | 10,919    |
| Average shares and dilutive potential common shares                                         | 2,158,273 | 2,148,713 | 2,155,902 | 1,939,708 |
| Diluted earnings per common share                                                           | \$0.49    | \$0.70    | \$1.29    | \$1.63    |
| Stock options not considered in computing earnings per share because they were antidilutive | 57,000    | 67,000    | 57,000    | 67,000    |

**6. Securities**

The following table summarizes the Corporation's securities as of September 30, 2016 and December 31, 2015:

| (Dollar amounts in thousands)                                | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--------------------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Available for sale:                                          |                   |                              |                               |               |
| September 30, 2016:                                          |                   |                              |                               |               |
| U.S. Treasury and federal agency                             | \$ 1,494          | \$ 11                        | \$ -                          | \$ 1,505      |
| U.S. government sponsored entities and agencies              | 6,999             | 2                            | (3)                           | 6,998         |
| U.S. agency mortgage-backed securities: residential          | 27,181            | 868                          | -                             | 28,049        |
| U.S. agency collateralized mortgage obligations: residential | 26,910            | 22                           | (231)                         | 26,701        |
| State and political subdivisions                             | 28,736            | 445                          | (9)                           | 29,172        |
| Corporate debt securities                                    | 8,012             | 30                           | (24)                          | 8,018         |
| Equity securities                                            | 1,829             | 230                          | (39)                          | 2,020         |
|                                                              | \$ 101,161        | \$ 1,608                     | \$ (306)                      | \$ 102,463    |
| December 31, 2015:                                           |                   |                              |                               |               |
| U.S. Treasury and federal agency                             | \$ 1,493          | \$ -                         | \$ (27)                       | \$ 1,466      |
| U.S. government sponsored entities and agencies              | 8,998             | 2                            | (47)                          | 8,953         |
| U.S. agency mortgage-backed securities: residential          | 32,947            | 256                          | (53)                          | 33,150        |
| U.S. agency collateralized mortgage obligations: residential | 32,289            | 23                           | (872)                         | 31,440        |
| State and political subdivisions                             | 28,352            | 264                          | (25)                          | 28,591        |
| Corporate debt securities                                    | 7,507             | 1                            | (21)                          | 7,487         |
| Equity securities                                            | 1,769             | 188                          | (63)                          | 1,894         |
|                                                              | \$ 113,355        | \$ 734                       | \$ (1,108)                    | \$ 112,981    |

The following table summarizes scheduled maturities of the Corporation's debt securities as of September 30, 2016. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

| (Dollar amounts in thousands)         | Available for sale<br>Amortized<br>Cost | Fair<br>Value |
|---------------------------------------|-----------------------------------------|---------------|
| Due in one year or less               | \$ 1,710                                | \$ 1,710      |
| Due after one year through five years | 17,664                                  | 17,767        |
| Due after five through ten years      | 24,606                                  | 24,960        |
| Due after ten years                   | 1,261                                   | 1,256         |

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|                                                  |          |           |
|--------------------------------------------------|----------|-----------|
| Mortgage-backed securities: residential          | 27,181   | 28,049    |
| Collateralized mortgage obligations: residential | 26,910   | 26,701    |
|                                                  | \$99,332 | \$100,443 |

**6. Securities (continued)**

Information pertaining to securities with gross unrealized losses at September 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

| (Dollar amounts in thousands)                                | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--------------------------------------------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                                                              | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| September 30, 2016:                                          |                     |                 |                   |                 |            |                 |
| U.S. government sponsored entities and agencies              | \$ 3,996            | \$ (3 )         | \$ -              | \$ -            | \$ 3,996   | \$ (3 )         |
| U.S. agency collateralized mortgage obligations: residential | 6,787               | (17 )           | 12,663            | (214 )          | 19,450     | (231 )          |
| State and political subdivisions                             | 1,655               | (9 )            | -                 | -               | 1,655      | (9 )            |
| Corporate debt securities                                    | 1,986               | (24 )           | -                 | -               | 1,986      | (24 )           |
| Equity securities                                            | 1,161               | (39 )           | -                 | -               | 1,161      | (39 )           |
|                                                              | \$ 15,585           | \$ (92 )        | \$ 12,663         | \$ (214 )       | \$ 28,248  | \$ (306 )       |
| December 31, 2015:                                           |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency                             | \$ -                | \$ -            | \$ 1,466          | \$ (27 )        | \$ 1,466   | \$ (27 )        |
| U.S. government sponsored entities and agencies              | 4,962               | (36 )           | 1,989             | (11 )           | 6,951      | (47 )           |
| U.S. agency mortgage-backed securities: residential          | 6,710               | (53 )           | -                 | -               | 6,710      | (53 )           |
| U.S. agency collateralized mortgage obligations: residential | 4,283               | (41 )           | 25,336            | (831 )          | 29,619     | (872 )          |
| State and political subdivisions                             | 1,028               | (2 )            | 1,819             | (23 )           | 2,847      | (25 )           |
| Corporate debt securities                                    | 3,484               | (20 )           | 500               | (1 )            | 3,984      | (21 )           |
| Equity securities                                            | 1,137               | (63 )           | -                 | -               | 1,137      | (63 )           |
|                                                              | \$ 21,604           | \$ (215 )       | \$ 31,110         | \$ (893 )       | \$ 52,714  | \$ (1,108 )     |

Gains on sales of available for sale securities for the three and nine months ended September 30 were as follows:

| (Dollar amounts in thousands)  | For the three months ended September 30, |           | For the nine months ended September 30, |           |
|--------------------------------|------------------------------------------|-----------|-----------------------------------------|-----------|
|                                | 2016                                     | 2015      | 2016                                    | 2015      |
| Proceeds                       | \$ -                                     | \$ 28,900 | \$ 6,118                                | \$ 30,691 |
| Gains                          | -                                        | 533       | 83                                      | 567       |
| Tax provision related to gains | -                                        | 181       | 28                                      | 193       |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Corporation intends to sell an impaired security, or if it is more likely than not the Corporation will be required to sell the security before its anticipated recovery, the Corporation records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost. Otherwise, only the credit portion of the estimated loss on debt securities is recognized in earnings, with the other portion of the loss recognized in other comprehensive income. For equity securities determined to be other-than-temporarily impaired, the entire amount of impairment is recognized through earnings.



**6. Securities (continued)**

There were two equity securities in an unrealized loss position as of September 30, 2016, both of which were in an unrealized loss position for less than 12 months. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment security is in unrealized loss positions as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability, capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell this security before the recovery of its amortized cost basis, the Corporation does not consider the equity security with an unrealized loss as of September 30, 2016 to be other-than-temporarily impaired.

There were 29 debt securities in an unrealized loss position as of September 30, 2016, of which 11 were in an unrealized loss position for more than 12 months. Of these 29 securities, 19 were government-backed collateralized mortgage obligations, 4 were corporate securities, 3 were U.S. government sponsored entity and agency securities and 3 were state and political subdivision securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of September 30, 2016 to be other-than-temporarily impaired.

**7. Loans Receivable and Related Allowance for Loan Losses**

The Corporation's loans receivable as of the respective dates are summarized as follows:

| (Dollar amounts in thousands)         | September 30,<br>2016 | December 31,<br>2015 |
|---------------------------------------|-----------------------|----------------------|
| Mortgage loans on real estate:        |                       |                      |
| Residential first mortgages           | \$ 190,034            | \$ 139,305           |
| Home equity loans and lines of credit | 91,545                | 87,410               |

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|                                |            |            |
|--------------------------------|------------|------------|
| Commercial real estate         | 162,652    | 129,691    |
|                                | 444,231    | 356,406    |
| Other loans:                   |            |            |
| Commercial business            | 62,549     | 71,948     |
| Consumer                       | 6,917      | 6,742      |
|                                | 69,466     | 78,690     |
| Total loans, gross             | 513,697    | 435,096    |
| Less allowance for loan losses | 5,514      | 5,205      |
| Total loans, net               | \$ 508,183 | \$ 429,891 |

Included in total loans above are net deferred costs of \$1.3 million and \$835,000 at September 30, 2016 and December 31, 2015, respectively.

An allowance for loan losses (ALL) is maintained to absorb probable incurred losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience and the amount of nonperforming loans.

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

The following table details activity in the ALL and the recorded investment by portfolio segment based on impairment method:

(Dollar amounts in thousands)

|                                              | Residential<br>Mortgages | Home<br>Equity<br>& Lines<br>of Credit | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Total    |
|----------------------------------------------|--------------------------|----------------------------------------|---------------------------|------------------------|----------|----------|
| Three months ended September 30,<br>2016:    |                          |                                        |                           |                        |          |          |
| Allowance for loan losses:                   |                          |                                        |                           |                        |          |          |
| Beginning Balance                            | \$ 1,696                 | \$ 645                                 | \$ 2,118                  | \$ 920                 | \$ 52    | \$ 5,431 |
| Charge-offs                                  | (22 )                    | (19 )                                  | (11 )                     | (11 )                  | (31 )    | (94 )    |
| Recoveries                                   | -                        | 1                                      | 2                         | -                      | 6        | 9        |
| Provision                                    | 58                       | (1 )                                   | 10                        | 75                     | 26       | 168      |
| Ending Balance                               | \$ 1,732                 | \$ 626                                 | \$ 2,119                  | \$ 984                 | \$ 53    | \$ 5,514 |
| Nine months ended September 30,<br>2016:     |                          |                                        |                           |                        |          |          |
| Allowance for loan losses:                   |                          |                                        |                           |                        |          |          |
| Beginning Balance                            | \$ 1,429                 | \$ 586                                 | \$ 2,185                  | \$ 960                 | \$ 45    | \$ 5,205 |
| Charge-offs                                  | (63 )                    | (52 )                                  | (11 )                     | (11 )                  | (45 )    | (182 )   |
| Recoveries                                   | -                        | 2                                      | 9                         | -                      | 10       | 21       |
| Provision                                    | 366                      | 90                                     | (64 )                     | 35                     | 43       | 470      |
| Ending Balance                               | \$ 1,732                 | \$ 626                                 | \$ 2,119                  | \$ 984                 | \$ 53    | \$ 5,514 |
| At September 30, 2016:                       |                          |                                        |                           |                        |          |          |
| Ending ALL balance attributable to<br>loans: |                          |                                        |                           |                        |          |          |
| Individually evaluated for impairment        | \$ 20                    | \$ -                                   | \$ -                      | \$ -                   | \$ -     | \$ 20    |
| Acquired loans                               | -                        | -                                      | -                         | -                      | -        | -        |
| Collectively evaluated for impairment        | 1,712                    | 626                                    | 2,119                     | 984                    | 53       | 5,494    |
| Total                                        | \$ 1,732                 | \$ 626                                 | \$ 2,119                  | \$ 984                 | \$ 53    | \$ 5,514 |

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|                                       |            |           |            |           |          |            |
|---------------------------------------|------------|-----------|------------|-----------|----------|------------|
| Total loans:                          |            |           |            |           |          |            |
| Individually evaluated for impairment | \$ 136     | \$ -      | \$ 791     | \$ 675    | \$ -     | \$ 1,602   |
| Acquired loans                        | 26,979     | 5,776     | 29,335     | 1,624     | 239      | 63,953     |
| Collectively evaluated for impairment | 162,919    | 85,769    | 132,526    | 60,250    | 6,678    | 448,142    |
| Total                                 | \$ 190,034 | \$ 91,545 | \$ 162,652 | \$ 62,549 | \$ 6,917 | \$ 513,697 |

At December 31, 2015:

Ending ALL balance attributable to loans:

|                                       |          |        |          |        |       |          |
|---------------------------------------|----------|--------|----------|--------|-------|----------|
| Individually evaluated for impairment | \$ 29    | \$ -   | \$ 5     | \$ 76  | \$ -  | \$ 110   |
| Collectively evaluated for impairment | 1,400    | 586    | 2,180    | 884    | 45    | 5,095    |
| Total                                 | \$ 1,429 | \$ 586 | \$ 2,185 | \$ 960 | \$ 45 | \$ 5,205 |

Total loans:

|                                       |            |           |            |           |          |            |
|---------------------------------------|------------|-----------|------------|-----------|----------|------------|
| Individually evaluated for impairment | \$ 169     | \$ -      | \$ 839     | \$ 999    | \$ -     | \$ 2,007   |
| Collectively evaluated for impairment | 139,136    | 87,410    | 128,852    | 70,949    | 6,742    | 433,089    |
| Total                                 | \$ 139,305 | \$ 87,410 | \$ 129,691 | \$ 71,948 | \$ 6,742 | \$ 435,096 |

Three months ended September 30, 2015:

Allowance for loan losses:

|                   |          |        |          |          |       |          |
|-------------------|----------|--------|----------|----------|-------|----------|
| Beginning Balance | \$ 1,258 | \$ 622 | \$ 2,161 | \$ 1,282 | \$ 47 | \$ 5,370 |
| Charge-offs       | (43 )    | (128 ) | (35 )    | -        | (3 )  | (209 )   |
| Recoveries        | -        | -      | 6        | 12       | 2     | 20       |
| Provision         | 173      | 122    | (164 )   | (232 )   | (1 )  | (102 )   |
| Ending Balance    | \$ 1,388 | \$ 616 | \$ 1,968 | \$ 1,062 | \$ 45 | \$ 5,079 |

Nine months ended September 30, 2015:

Allowance for loan losses:

|                   |          |        |          |          |       |          |
|-------------------|----------|--------|----------|----------|-------|----------|
| Beginning Balance | \$ 955   | \$ 543 | \$ 2,338 | \$ 1,336 | \$ 52 | \$ 5,224 |
| Charge-offs       | (47 )    | (213 ) | (35 )    | (182 )   | (32 ) | (509 )   |
| Recoveries        | -        | 30     | 18       | 31       | 16    | 95       |
| Provision         | 480      | 256    | (353 )   | (123 )   | 9     | 269      |
| Ending Balance    | \$ 1,388 | \$ 616 | \$ 1,968 | \$ 1,062 | \$ 45 | \$ 5,079 |

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

The allowance for loan losses is based on estimates and actual losses may vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk found in the components of the portfolio at any given date.

At September 30, 2016, there was no allowance for loan losses allocated to loans acquired in the April 2016 merger with United American.

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of September 30, 2016:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                                            |                      | For the three months              |                                            | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|----------------------------------------|--------------------------------------------|----------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | As of September 30, 2016               |                                            |                      | ended September 30, 2016          |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance         | Recorded<br>Investment                     | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |                                                   |
| Residential first mortgages     | \$ 169                                 | \$ 136                                     | \$ 20                | \$ 107                            | \$ 3                                       | \$ 3                                              |
| Home equity and lines of credit | -                                      | -                                          | -                    | -                                 | -                                          | -                                                 |
| Commercial real estate          | -                                      | -                                          | -                    | -                                 | -                                          | -                                                 |
| Commercial business             | -                                      | -                                          | -                    | -                                 | -                                          | -                                                 |
| Consumer                        | -                                      | -                                          | -                    | -                                 | -                                          | -                                                 |
| <b>Total</b>                    | <b>\$ 169</b>                          | <b>\$ 136</b>                              | <b>\$ 20</b>         | <b>\$ 107</b>                     | <b>\$ 3</b>                                | <b>\$ 3</b>                                       |
|                                 | For the nine months                    |                                            |                      | For the nine months               |                                            |                                                   |
|                                 | ended September 30, 2016               |                                            |                      | ended September 30, 2016          |                                            |                                                   |
|                                 | Average<br>Recorded<br>Investment      | Interest Income<br>Recognized<br>in Period |                      | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$ 115                                 | \$ 5                                       |                      | \$ 5                              |                                            |                                                   |
| Home equity and lines of credit | -                                      | -                                          |                      | -                                 |                                            |                                                   |

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|                        |        |      |      |
|------------------------|--------|------|------|
| Commercial real estate | 23     | -    | -    |
| Commercial business    | 388    | -    | -    |
| Consumer               | -      | -    | -    |
| Total                  | \$ 526 | \$ 5 | \$ 5 |

Impaired Loans with No Specific Allowance  
For the three months

As of September 30, 2016 ended September 30, 2016

|                                 | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Average Interest<br>Recorded<br>Investment | Interest<br>Recognized<br>Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|--------------------------------|------------------------|--------------------------------------------|----------------------------------|---------------------------------------------------|
| Residential first mortgages     | \$-                            | \$ -                   | \$29                                       | \$ -                             | \$ -                                              |
| Home equity and lines of credit | -                              | -                      | -                                          | -                                | -                                                 |
| Commercial real estate          | 1,190                          | 791                    | 807                                        | 1                                | 1                                                 |
| Commercial business             | 675                            | 675                    | 682                                        | -                                | -                                                 |
| Consumer                        | -                              | -                      | -                                          | -                                | -                                                 |
| Total                           | \$1,865                        | \$ 1,466               | \$1,518                                    | \$ 1                             | \$ 1                                              |

For the nine months  
ended September 30, 2016

|                                 | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
| Residential first mortgages     | \$ 29                             | \$ -                                       | \$ -                                              |
| Home equity and lines of credit | -                                 | -                                          | -                                                 |
| Commercial real estate          | 804                               | 2                                          | 2                                                 |
| Commercial business             | 379                               | 1                                          | 1                                                 |
| Consumer                        | -                                 | -                                          | -                                                 |
| Total                           | \$ 1,212                          | \$ 3                                       | \$ 3                                              |

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2015:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance    |                        |                      | For the year ended                |                                            | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-------------------------------------------|------------------------|----------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | As of December 31, 2015                   |                        |                      | December 31, 2015                 |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance            | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |                                                   |
| Residential first mortgages     | \$169                                     | \$ 169                 | \$ 29                | \$170                             | \$ 6                                       | \$ 6                                              |
| Home equity and lines of credit | -                                         | -                      | -                    | -                                 | -                                          | -                                                 |
| Commercial real estate          | 93                                        | 93                     | 5                    | 1,613                             | 12                                         | 9                                                 |
| Commercial business             | 923                                       | 923                    | 76                   | 1,641                             | 112                                        | 99                                                |
| Consumer                        | -                                         | -                      | -                    | -                                 | -                                          | -                                                 |
| <b>Total</b>                    | <b>\$1,185</b>                            | <b>\$ 1,185</b>        | <b>\$ 110</b>        | <b>\$3,424</b>                    | <b>\$ 130</b>                              | <b>\$ 114</b>                                     |
|                                 | Impaired Loans with No Specific Allowance |                        |                      | For the year ended                |                                            |                                                   |
|                                 | As of December 31, 2015                   |                        |                      | December 31, 2015                 |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance            | Recorded<br>Investment |                      | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$ -                                      | \$ -                   |                      | \$ 45                             | \$ 7                                       | \$ 7                                              |
| Home equity and lines of credit | -                                         | -                      |                      | -                                 | -                                          | -                                                 |
| Commercial real estate          | 1,145                                     | 746                    |                      | 1,069                             | 49                                         | 40                                                |
| Commercial business             | 76                                        | 76                     |                      | 66                                | 3                                          | 3                                                 |
| Consumer                        | -                                         | -                      |                      | -                                 | -                                          | -                                                 |
| <b>Total</b>                    | <b>\$ 1,221</b>                           | <b>\$ 822</b>          |                      | <b>\$ 1,180</b>                   | <b>\$ 59</b>                               | <b>\$ 50</b>                                      |

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of September 30, 2015:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                        |                      | For the three months              |                                            | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|----------------------------------------|------------------------|----------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | As of September 30, 2015               |                        |                      | ended September 30, 2015          |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance         | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |                                                   |
| Residential first mortgages     | \$ 170                                 | \$ 170                 | \$ 28                | \$ 169                            | \$ 2                                       | \$ 2                                              |
| Home equity and lines of credit | -                                      | -                      | -                    | -                                 | -                                          | -                                                 |
| Commercial real estate          | 94                                     | 94                     | 5                    | 1,345                             | 8                                          | 8                                                 |
| Commercial business             | 940                                    | 940                    | 158                  | 1,050                             | 4                                          | 4                                                 |
| Consumer                        | -                                      | -                      | -                    | -                                 | -                                          | -                                                 |
| <b>Total</b>                    | <b>\$ 1,204</b>                        | <b>\$ 1,204</b>        | <b>\$ 191</b>        | <b>\$ 2,564</b>                   | <b>\$ 14</b>                               | <b>\$ 14</b>                                      |

|                                 | For the nine months               |                                            |               | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-----------------------------------|--------------------------------------------|---------------|---------------------------------------------------|
|                                 | ended September 30, 2015          |                                            |               |                                                   |
|                                 | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |               |                                                   |
| Residential first mortgages     | \$ 170                            | \$ 6                                       | \$ 6          |                                                   |
| Home equity and lines of credit | -                                 | -                                          | -             |                                                   |
| Commercial real estate          | 1,993                             | 11                                         | 11            |                                                   |
| Commercial business             | 1,820                             | 122                                        | 110           |                                                   |
| Consumer                        | -                                 | -                                          | -             |                                                   |
| <b>Total</b>                    | <b>\$ 3,983</b>                   | <b>\$ 139</b>                              | <b>\$ 127</b> |                                                   |

|  | Impaired Loans with No Specific Allowance |         |                 | Cash Basis<br>Interest |
|--|-------------------------------------------|---------|-----------------|------------------------|
|  | As of September 30, 2015                  |         |                 |                        |
|  | Unpaid                                    | Average | Interest Income |                        |
|  |                                           |         |                 |                        |
|  |                                           |         |                 |                        |
|  |                                           |         |                 |                        |



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|                                 | Principal<br>Balance | Recorded<br>Investment | Recorded<br>Investment | Recognized<br>in Period | Recognized<br>in Period |
|---------------------------------|----------------------|------------------------|------------------------|-------------------------|-------------------------|
| Residential first mortgages     | \$ -                 | \$ -                   | \$ -                   | \$ -                    | \$ -                    |
| Home equity and lines of credit | -                    | -                      | -                      | -                       | -                       |
| Commercial real estate          | 3,871                | 2,530                  | 1,468                  | 9                       | 1                       |
| Commercial business             | 77                   | 77                     | 75                     | -                       | -                       |
| Consumer                        | -                    | -                      | -                      | -                       | -                       |
| Total                           | \$ 3,948             | \$ 2,607               | \$ 1,543               | \$ 9                    | \$ 1                    |

For the nine months  
ended September 30, 2015

|                                 | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
| Residential first mortgages     | \$ 56                             | \$ 7                                       | \$ 7                                              |
| Home equity and lines of credit | -                                 | -                                          | -                                                 |
| Commercial real estate          | 1,150                             | 47                                         | 39                                                |
| Commercial business             | 63                                | 2                                          | 2                                                 |
| Consumer                        | -                                 | -                                          | -                                                 |
| Total                           | \$ 1,269                          | \$ 56                                      | \$ 48                                             |

Unpaid principal balance includes any loans that have been partially charged off but not forgiven. Accrued interest is not included in the recorded investment in loans presented above or in the tables that follow based on the amounts not being material.

## 7. Loans Receivable and Related Allowance for Loan Losses (continued)

**Troubled debt restructurings (TDR).** The Corporation has certain loans that have been modified in order to maximize collection of loan balances. If, for economic or legal reasons related to the customer's financial difficulties, management grants a concession compared to the original terms and conditions of the loan that it would not have otherwise considered, the modified loan is classified as a TDR. Concessions related to TDRs generally do not include forgiveness of principal balances. The Corporation generally does not extend additional credit to borrowers with loans classified as TDRs.

At September 30, 2016 and December 31, 2015, the Corporation had \$390,000 and \$835,000, respectively, of loans classified as TDRs, which are included in impaired loans above. The Corporation had allocated \$20,000 and \$63,000 of specific allowance for these loans at September 30, 2016 and December 31, 2015, respectively.

During the three and nine month periods ended September 30, 2016, the Corporation modified one home equity loan with a recorded investment of \$10,000 due to a bankruptcy order. At September 30, 2016, the Corporation did not have any allowance for loan losses allocated to this specific loan. The modification did not have a material impact on the Corporation's income statement during the periods. During the three and nine month periods ended September 30, 2015, the Corporation did not modify any loans as TDRs.

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms. During the three and nine month periods ended September 30, 2016, there was a default on one \$10,000 home equity loan within 12 months following modification. The default did not have a material impact on the Corporation's income statement during the periods. During the three and nine month periods ended September 30, 2015, there was a default on one \$90,000 residential mortgage loan within 12 months following modification. The default did not have a material impact on the Corporation's income statement during the periods.

**Credit Quality Indicators.** Management categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors.

Commercial real estate and commercial business loans not identified as impaired are evaluated as risk rated pools of loans utilizing a risk rating practice that is supported by a quarterly special asset review. In this review process, strengths and weaknesses are identified, evaluated and documented for each criticized and classified loan and borrower, strategic action plans are developed, risk ratings are confirmed and the loan's performance status is reviewed.

Management has determined certain portions of the loan portfolio to be homogeneous in nature and assigns like reserve factors for the following loan pool types: residential real estate, home equity loans and lines of credit, and consumer installment and personal lines of credit.

The reserve allocation for risk rated loan pools is developed by applying the following factors:

Historic: Management utilizes a computer model to develop the historical net charge-off experience which is used to formulate the assumptions employed in the migration analysis applied to estimate losses in the portfolio. Outstanding balance and charge-off information are input into the model and historical loss migration rate assumptions are developed to apply to pass, special mention, substandard and doubtful risk rated loans. A twelve-quarter rolling weighted-average is utilized to estimate probable incurred losses in the portfolios.

Qualitative: Qualitative adjustment factors for pass, special mention, substandard and doubtful ratings are developed and applied to risk rated loans to allow for: quality of lending policies and procedures; national and local economic and business conditions; changes in the nature and volume of the portfolio; experiences, ability and depth of lending management; changes in trends, volume and severity of past due, nonaccrual and classified loans and loss and recovery trends; quality of loan review systems; concentrations of credit and other external factors.

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

Management uses the following definitions for risk ratings:

**Pass:** Loans classified as pass typically exhibit good payment performance and have underlying borrowers with acceptable financial trends where repayment capacity is evident. These borrowers typically would have a sufficient cash flow that would allow them to weather an economic downturn and the value of any underlying collateral could withstand a moderate degree of depreciation due to economic conditions.

**Special Mention:** Loans classified as special mention are characterized by potential weaknesses that could jeopardize repayment as contractually agreed. These loans may exhibit adverse trends such as increasing leverage, shrinking profit margins and/or deteriorating cash flows. These borrowers would inherently be more vulnerable to the application of economic pressures.

**Substandard:** Loans classified as substandard exhibit weaknesses that are well-defined to the point that repayment is jeopardized. Typically, the Corporation is no longer adequately protected by both the apparent net worth and repayment capacity of the borrower.

**Doubtful:** Loans classified as doubtful have advanced to the point that collection or liquidation in full, on the basis of currently ascertainable facts, conditions and value, is highly questionable or improbable.

The following table presents the classes of the loan portfolio summarized by the aggregate pass and the criticized categories of special mention, substandard and doubtful within the Corporation's internal risk rating system as of September 30, 2016 and December 31, 2015:

(Dollar amounts in thousands)

|                                 | Not Rated  | Pass    | Special<br>Mention | Substandard | Doubtful | Total     |
|---------------------------------|------------|---------|--------------------|-------------|----------|-----------|
| September 30, 2016:             |            |         |                    |             |          |           |
| Residential first mortgages     | \$ 188,455 | \$-     | \$ -               | \$ 1,579    | \$ -     | \$190,034 |
| Home equity and lines of credit | 91,276     | -       | -                  | 269         | -        | 91,545    |
| Commercial real estate          | -          | 158,106 | 45                 | 4,501       | -        | 162,652   |
| Commercial business             | -          | 54,106  | 5,071              | 3,372       | -        | 62,549    |

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|                                 |           |           |         |         |     |           |
|---------------------------------|-----------|-----------|---------|---------|-----|-----------|
| Consumer                        | 6,917     | -         | -       | -       | -   | 6,917     |
| Total                           | \$286,647 | \$212,212 | \$5,116 | \$9,721 | \$- | \$513,697 |
| December 31, 2015:              |           |           |         |         |     |           |
| Residential first mortgages     | \$138,096 | \$-       | \$-     | \$1,209 | \$- | \$139,305 |
| Home equity and lines of credit | 87,015    | -         | -       | 395     | -   | 87,410    |
| Commercial real estate          | -         | 125,539   | 88      | 4,064   | -   | 129,691   |
| Commercial business             | -         | 69,740    | 942     | 1,266   | -   | 71,948    |
| Consumer                        | 6,742     | -         | -       | -       | -   | 6,742     |
| Total                           | \$231,853 | \$195,279 | \$1,030 | \$6,934 | \$- | \$435,096 |

**7.Loans Receivable and Related Allowance for Loan Losses (continued)**

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of September 30, 2016 and December 31, 2015:

(Dollar amounts in thousands)

|                                 | Performing<br>Accruing | Accruing<br>30-59 Days<br>Past Due | Accruing<br>60-89 Days<br>Past Due | Nonperforming<br>Accruing<br>90<br>Days<br>+<br>Past<br>Due | Nonaccrual      | Total<br>Loans    |
|---------------------------------|------------------------|------------------------------------|------------------------------------|-------------------------------------------------------------|-----------------|-------------------|
| September 30, 2016:             |                        |                                    |                                    |                                                             |                 |                   |
| Residential first mortgages     | \$ 186,528             | \$ 1,792                           | \$ 213                             | \$ -                                                        | \$ 1,501        | \$ 190,034        |
| Home equity and lines of credit | 90,940                 | 254                                | 85                                 | -                                                           | 266             | 91,545            |
| Commercial real estate          | 160,950                | 751                                | 66                                 | 3                                                           | 882             | 162,652           |
| Commercial business             | 61,864                 | 10                                 | -                                  | -                                                           | 675             | 62,549            |
| Consumer                        | 6,871                  | 22                                 | 24                                 | -                                                           | -               | 6,917             |
| <b>Total loans</b>              | <b>\$ 507,153</b>      | <b>\$ 2,829</b>                    | <b>\$ 388</b>                      | <b>\$ 3</b>                                                 | <b>\$ 3,324</b> | <b>\$ 513,697</b> |
| December 31, 2015:              |                        |                                    |                                    |                                                             |                 |                   |
| Residential first mortgages     | \$ 136,924             | \$ 1,097                           | \$ 75                              | \$ -                                                        | \$ 1,209        | \$ 139,305        |
| Home equity and lines of credit | 86,691                 | 308                                | 16                                 | -                                                           | 395             | 87,410            |
| Commercial real estate          | 128,945                | -                                  | -                                  | -                                                           | 746             | 129,691           |
| Commercial business             | 71,229                 | -                                  | -                                  | -                                                           | 719             | 71,948            |
| Consumer                        | 6,723                  | 19                                 | -                                  | -                                                           | -               | 6,742             |
| <b>Total loans</b>              | <b>\$ 430,512</b>      | <b>\$ 1,424</b>                    | <b>\$ 91</b>                       | <b>\$ -</b>                                                 | <b>\$ 3,069</b> | <b>\$ 435,096</b> |

The following table presents the Corporation's nonaccrual loans by aging category as of September 30, 2016 and December 31, 2015:

(Dollar amounts in thousands)

| Not<br>Past Due | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days +<br>Past Due | Total<br>Loans |
|-----------------|------------------------|------------------------|-----------------------|----------------|
|-----------------|------------------------|------------------------|-----------------------|----------------|

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September 30, 2016:

|                                 |          |       |       |          |         |
|---------------------------------|----------|-------|-------|----------|---------|
| Residential first mortgages     | \$ 73    | \$ 77 | \$ -  | \$ 1,351 | \$1,501 |
| Home equity and lines of credit | -        | -     | 12    | 254      | 266     |
| Commercial real estate          | 551      | 6     | -     | 325      | 882     |
| Commercial business             | 646      | -     | -     | 29       | 675     |
| Consumer                        | -        | -     | -     | -        | -       |
| Total loans                     | \$ 1,270 | \$ 83 | \$ 12 | \$ 1,959 | \$3,324 |

December 31, 2015:

|                                 |          |      |       |          |         |
|---------------------------------|----------|------|-------|----------|---------|
| Residential first mortgages     | \$ 75    | \$ - | \$ 79 | \$ 1,055 | \$1,209 |
| Home equity and lines of credit | 14       | -    | -     | 381      | 395     |
| Commercial real estate          | 623      | -    | -     | 123      | 746     |
| Commercial business             | 690      | -    | -     | 29       | 719     |
| Consumer                        | -        | -    | -     | -        | -       |
| Total loans                     | \$ 1,402 | \$ - | \$ 79 | \$ 1,588 | \$3,069 |

## 8. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of September 30, 2016 and December 31, 2015:

| (Dollar amounts in thousands) | September 30, 2016    |                          | December 31, 2015     |                          |
|-------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                               | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Goodwill                      | \$ 10,291             | \$ -                     | \$ 3,664              | \$ -                     |
| Core deposit intangibles      | 4,259                 | 3,638                    | 4,027                 | 3,473                    |
| Total                         | \$ 14,550             | \$ 3,638                 | \$ 7,691              | \$ 3,473                 |

Goodwill resulted from four acquisitions. During the nine months ended September 30, 2016, the Corporation recorded \$6.6 million of goodwill related to the acquisition of United American (see Note 2). Goodwill represents the excess of the total purchase price paid for the acquisitions over the fair value of the identifiable assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. The Corporation has selected November 30 as the date to perform the annual impairment test. No goodwill impairment charges were recorded during 2015 or in the first nine months of 2016.

The core deposit intangible asset, resulting from two acquisitions, is amortized using the double declining balance method over a weighted average estimated life of the related deposits and is not estimated to have a significant residual value. During the three and nine month periods ending September 30, 2016, the Corporation recorded intangible amortization expense totaling \$60,000 and \$165,000, respectively, compared to \$49,000 and \$146,000, respectively, for the same periods in 2015. Core deposit intangible expense projected for the succeeding five years beginning 2016 is estimated to be \$226,000, \$235,000, \$196,000, \$26,000 and \$20,000 per year, respectively, and \$83,000 in total for years after 2020.

## 9. Stock Compensation Plans

In April 2014, the Corporation adopted the 2014 Stock Incentive Plan (the 2014 Plan), which is shareholder approved and permits the grant of restricted stock awards and options to its directors, officers and employees for up to 176,866 shares of common stock. As of September 30, 2016, 75,483 shares of restricted stock and 88,433 stock options remain available for issuance under the plan.



In addition, the Corporation's 2007 Stock Incentive Plan and Trust (the 2007 Plan), which is shareholder approved, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock. As of September 30, 2016, 1,313 shares of restricted stock and 45,283 stock options remain available for issuance under the plan.

Incentive stock options, non-incentive or compensatory stock options and share awards may be granted under the Plans. The exercise price of each option shall at least equal the market price of a share of common stock on the date of grant and have a contractual term of ten years. Options shall vest and become exercisable at the rate, to the extent and subject to such limitations as may be specified by the Corporation. Compensation cost related to share-based payment transactions must be recognized in the financial statements with measurement based upon the fair value of the equity instruments issued.

**9. Stock Compensation Plans (continued)**

A summary of option activity under the Plans as of September 30, 2016, and changes during the period then ended is presented below:

|                                      | Options  | Weighted-Average<br>Exercise Price | Aggregate<br>Intrinsic Value<br>(in thousands) | Weighted-Average<br>Remaining Term<br>(in years) |
|--------------------------------------|----------|------------------------------------|------------------------------------------------|--------------------------------------------------|
| Outstanding as of January 1, 2016    | 73,000   | \$ 25.71                           | \$ 9,000                                       | 1.6                                              |
| Granted                              | -        | -                                  | -                                              | -                                                |
| Exercised                            | -        | -                                  | -                                              | -                                                |
| Forfeited                            | (11,000) | 25.68                              | -                                              | -                                                |
| Outstanding as of September 30, 2016 | 62,000   | \$ 25.71                           | \$ 10,600                                      | 0.8                                              |
| Exercisable as of September 30, 2016 | 62,000   | \$ 25.71                           | \$ 10,600                                      | 0.8                                              |

A summary of the status of the Corporation's nonvested restricted stock awards as of September 30, 2016, and changes during the period then ended is presented below:

|                                    | Shares  | Weighted-Average<br>Grant-date Fair Value |
|------------------------------------|---------|-------------------------------------------|
| Nonvested at January 1, 2016       | 23,450  | \$ 24.38                                  |
| Granted                            | -       | -                                         |
| Vested                             | (1,500) | 24.51                                     |
| Forfeited                          | -       | -                                         |
| Nonvested as of September 30, 2016 | 21,950  | \$ 24.37                                  |

For the three and nine month periods ended September 30, 2016, the Corporation recognized \$44,000 and \$154,000, respectively, in stock compensation expense, compared to \$42,000 and \$150,000, respectively, for the same periods in 2015. As of September 30, 2016, there was \$237,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 1.3 years. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.

**10. Fair Value**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair value.

*Level 1:* Quoted prices (unadjusted) for identical assets or liabilities in active markets that the Corporation has the ability to access at the measurement date.

*Level 2:* Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

*Level 3:* Significant unobservable inputs that reflect the Corporation's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

An asset or liability's level is based on the lowest level of input that is significant to the fair value measurement.

The Corporation used the following methods and significant assumptions to estimate fair value:

*Cash and cash equivalents* – The carrying value of cash and due from banks and interest earning deposits with banks approximates fair value and are classified as Level 1.

**10. Fair Value (continued)**

*Securities available for sale* – The fair value of all investment securities are based upon the assumptions market participants would use in pricing the security. If available, investment securities are determined by quoted market prices (Level 1). Level 1 includes U.S. Treasury, federal agency securities and certain equity securities. For investment securities where quoted market prices are not available, fair values are calculated based on market prices on similar securities (Level 2). Level 2 includes U.S. Government sponsored entities and agencies, mortgage-backed securities, collateralized mortgage obligations, state and political subdivision securities and corporate debt securities. For investment securities where quoted prices or market prices of similar securities are not available, fair values are calculated by using unobservable inputs (Level 3) and may include certain equity securities held by the Corporation. The Level 3 equity security valuations were supported by an analysis prepared by the Corporation which relies on inputs such as the security issuer's publicly attainable financial information, multiples derived from prices in observed transactions involving comparable businesses and other market, financial and nonfinancial factors.

*Loans* – The fair value of loans receivable was estimated based on the discounted value of the future cash flows using the current rates being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification.

*Impaired loans* – At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of September 30, 2016, the fair value of impaired loans measured using the fair value of collateral consisted of loan balances of \$59,000, net of a valuation allowance of \$1,000, compared to loan balances of \$643,000, net of a valuation allowance of \$47,000, at December 31, 2015. There was no additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2016. There was \$0 and \$235,000 of additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2015.

*Other real estate owned (OREO)* – Assets acquired through or instead of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Management's ongoing review of appraisal information may result in additional discounts or adjustments to the valuation based upon more recent market sales activity or more current appraisal information derived from properties

of similar type and/or locale. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. As of September 30, 2016, the Corporation had no OREO measured at fair value. At December 31, 2015, OREO measured at fair value less costs to sell had a net carrying amount of \$13,000, which consisted of the outstanding balance of \$22,000 less write-downs of \$9,000. There was no expense recorded during the three and nine month periods ended September 30, 2016 associated with the write-down of OREO, compared \$0 and \$3,000, respectively for the three and nine month periods ended September 30, 2015.

**10. Fair Value (continued)**

Appraisals for both collateral-dependent impaired loans and OREO are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed by the Corporation. Once received, management reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On an annual basis, the Corporation compares the actual selling price of OREO that has been sold to the most recent appraisal to determine what additional adjustment should be made to the appraisal value to arrive at fair value. The most recent analysis performed indicated that a discount of 10% should be applied.

*Federal bank stock* – It is not practical to determine the fair value of federal bank stocks due to restrictions placed on its transferability.

*Deposits* – The fair value of deposits with no stated maturity, such as non-interest bearing demand deposits, checking with interest, savings and money market accounts, is equal to the amount payable on demand resulting in either a Level 1 or Level 2 classification. The fair values of time deposits are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar maturities resulting in a Level 2 classification.

*Borrowings* – The fair value of borrowings with the FHLB is estimated using discounted cash flows based on current incremental borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

*Accrued interest receivable and payable* – The carrying value of accrued interest receivable and payable approximates fair value. The fair value classification is consistent with the related financial instrument.

For assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

| (Dollar amounts in thousands) |       | (Level 1)                                                     | (Level 2)                                    |                                                    |
|-------------------------------|-------|---------------------------------------------------------------|----------------------------------------------|----------------------------------------------------|
| Description                   | Total | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|                               |       |                                                               |                                              |                                                    |

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September 30, 2016:

|                                                              |           |          |           |        |
|--------------------------------------------------------------|-----------|----------|-----------|--------|
| U.S. Treasury and federal agency                             | \$1,505   | \$ 1,505 | \$ -      | \$ -   |
| U.S. government sponsored entities and agencies              | 6,998     | -        | 6,998     | -      |
| U.S. agency mortgage-backed securities: residential          | 28,049    | -        | 28,049    | -      |
| U.S. agency collateralized mortgage obligations: residential | 26,701    | -        | 26,701    | -      |
| State and political subdivision                              | 29,172    | -        | 29,172    | -      |
| Corporate debt securities                                    | 8,018     | -        | 8,018     | -      |
| Equity securities                                            | 2,020     | 1,885    | -         | 135    |
|                                                              | \$102,463 | \$ 3,390 | \$ 98,938 | \$ 135 |

December 31, 2015:

|                                                              |           |          |            |       |
|--------------------------------------------------------------|-----------|----------|------------|-------|
| U.S. Treasury and federal agency                             | \$1,466   | \$ 1,466 | \$ -       | \$ -  |
| U.S. government sponsored entities and agencies              | 8,953     | -        | 8,953      | -     |
| U.S. agency mortgage-backed securities: residential          | 33,150    | -        | 33,150     | -     |
| U.S. agency collateralized mortgage obligations: residential | 31,440    | -        | 31,440     | -     |
| State and political subdivisions                             | 28,591    | -        | 28,591     | -     |
| Corporate debt securities                                    | 7,487     | -        | 7,487      | -     |
| Equity securities                                            | 1,894     | 1,820    | -          | 74    |
|                                                              | \$112,981 | \$ 3,286 | \$ 109,621 | \$ 74 |

**10. Fair Value (continued)**

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and nine month periods ended September 30, 2016 and 2015, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the three and nine month periods ended September 30, 2016 and 2015:

| (Dollar amounts in thousands)                | Three months ended |        | Nine months ended |        |
|----------------------------------------------|--------------------|--------|-------------------|--------|
|                                              | September 30,      |        | September 30,     |        |
|                                              | 2016               | 2015   | 2016              | 2015   |
| Balance at the beginning of the period       | \$ 135             | \$ 835 | \$ 74             | \$ 898 |
| Total gains or losses (realized/unrealized): | -                  | -      | -                 | -      |
| Included in earnings                         | -                  | -      | -                 | -      |
| Included in other comprehensive income       | -                  | (3 )   | 1                 | (66 )  |
| Acquired                                     | -                  | -      | 60                | -      |
| Transfers in and/or out of Level 3           | -                  | -      | -                 | -      |
| Balance at the end of the period             | \$ 135             | \$ 832 | \$ 135            | \$ 832 |

For assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

| (Dollar amounts in thousands)       | Total | (Level 1)                                            | (Level 2)                           | (Level 3)                       |
|-------------------------------------|-------|------------------------------------------------------|-------------------------------------|---------------------------------|
|                                     |       | Quoted Prices in Active Markets for Identical Assets | Significant Other Observable Inputs | Significant Unobservable Inputs |
| Description                         |       |                                                      |                                     |                                 |
| September 30, 2016:                 |       |                                                      |                                     |                                 |
| Impaired residential mortgage loan  | \$58  | \$ -                                                 | \$ -                                | \$ 58                           |
| December 31, 2015:                  |       |                                                      |                                     |                                 |
| Impaired commercial business loans  | \$596 | \$ -                                                 | \$ -                                | \$ 596                          |
| Other residential real estate owned | 13    | -                                                    | -                                   | 13                              |
|                                     | \$609 | \$ -                                                 | \$ -                                | \$ 609                          |
| Other real estate owned             |       | -                                                    | -                                   | -                               |



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The following table presents quantitative information about Level 3 fair value measurements for assets measured at fair value on a non-recurring basis:

| (Dollar amounts in thousands)       |       | Valuation Techniques(s)              | Unobservable Input (s)                                        | Weighted Average |   |
|-------------------------------------|-------|--------------------------------------|---------------------------------------------------------------|------------------|---|
| September 30, 2016:                 |       |                                      |                                                               |                  |   |
| Impaired residential mortgage loan  | \$58  | Sales comparison approach            | Adjustment for differences between comparable sales           | 10               | % |
| December 31, 2015:                  |       |                                      |                                                               |                  |   |
| Impaired commercial business loans  | \$596 | Liquidation value of business assets | Adjustment for differences between comparable business assets | 65               | % |
| Other residential real estate owned | 13    | Sales comparison approach            | Adjustment for differences between comparable sales           | 10               | % |

The two tables above exclude an impaired residential mortgage loan totaling \$77,000 classified as a TDR which was measured using a discounted cash flow methodology at September 30, 2016. Excluded at December 31, 2015 were two impaired residential mortgage loans totaling \$140,000, an \$89,000 impaired commercial real estate loan and a \$250,000 impaired commercial business loan classified as TDRs which were measured using a discounted cash flow methodology.

**10. Fair Value (continued)**

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of September 30, 2016 and December 31, 2015:

(Dollar amounts in thousands)

| Description                   | Carrying Amount | Fair Value Measurements using: |           |           |           |
|-------------------------------|-----------------|--------------------------------|-----------|-----------|-----------|
|                               |                 | Total                          | Level 1   | Level 2   | Level 3   |
| <b>September 30, 2016:</b>    |                 |                                |           |           |           |
| <b>Financial Assets:</b>      |                 |                                |           |           |           |
| Cash and cash equivalents     | \$26,804        | \$26,804                       | \$26,804  | \$-       | \$-       |
| Securities available for sale | 102,463         | 102,463                        | 3,390     | 98,938    | 135       |
| Loans held for sale           | 58              | 58                             | -         | 58        | -         |
| Loans, net                    | 508,183         | 520,505                        | -         | -         | 520,505   |
| Federal bank stock            | 3,854           | N/A                            | N/A       | N/A       | N/A       |
| Accrued interest receivable   | 1,969           | 1,969                          | 54        | 387       | 1,528     |
|                               | \$643,331       | \$651,799                      | \$30,248  | \$99,383  | \$522,168 |
| <b>Financial Liabilities:</b> |                 |                                |           |           |           |
| Deposits                      | 592,600         | 594,700                        | 424,077   | 170,623   | -         |
| Borrowed funds                | 37,250          | 37,718                         | -         | 37,718    | -         |
| Accrued interest payable      | 236             | 236                            | 8         | 228       | -         |
|                               | \$630,086       | \$632,654                      | \$424,085 | \$208,569 | \$-       |

| Description                   | Carrying Amount | Fair Value Measurements using: |           |           |           |
|-------------------------------|-----------------|--------------------------------|-----------|-----------|-----------|
|                               |                 | Total                          | Level 1   | Level 2   | Level 3   |
| <b>December 31, 2015:</b>     |                 |                                |           |           |           |
| <b>Financial Assets:</b>      |                 |                                |           |           |           |
| Cash and cash equivalents     | \$11,546        | \$11,546                       | \$11,546  | \$-       | \$-       |
| Securities available for sale | 112,981         | 112,981                        | 3,286     | 109,621   | 74        |
| Loans, net                    | 429,891         | 436,009                        | -         | -         | 436,009   |
| Federal bank stock            | 4,240           | N/A                            | N/A       | N/A       | N/A       |
| Accrued interest receivable   | 1,501           | 1,501                          | 64        | 299       | 1,138     |
|                               | \$560,159       | \$562,037                      | \$14,896  | \$109,920 | \$437,221 |
| <b>Financial Liabilities:</b> |                 |                                |           |           |           |
| Deposits                      | 489,887         | 491,781                        | 376,409   | 115,372   | -         |
| Borrowed funds                | 49,250          | 50,636                         | -         | 50,636    | -         |
| Accrued interest payable      | 179             | 179                            | 5         | 174       | -         |
|                               | \$539,316       | \$542,596                      | \$376,414 | \$166,182 | \$-       |

**11. Regulatory Matters**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (BASEL III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019.

Quantitative measures established by the regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 capital and common equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined).

**11. Regulatory Matters (continued)**

In 2015, the Board of Governors of the Federal Reserve System amended its Small Bank Holding Company Policy Statement by increasing the policy's consolidated assets threshold from \$500 million to \$1 billion. The primary benefit of being deemed a "small bank holding company" is the exemption from the requirement to maintain consolidated regulatory capital ratios; instead, regulatory capital ratios only apply at the subsidiary bank level. In addition, the Bank in its March 31, 2015 quarterly filing made a one-time permanent election to continue to exclude accumulated other comprehensive income from capital.

On July 2, 2013, the Federal Reserve Board and the FDIC approved rules that implement the "Basel III" regulatory capital reforms, as well as certain changes required by the Dodd-Frank Act. The rules include a common equity Tier 1 capital ratio and conservation buffer of 2.5% of risk-weighted assets, which is in addition to the Tier 1 and Tier 2 risk-based capital requirements. The capital conservation buffer will be phased in over four years beginning on January 1, 2016, with a maximum buffer of 0.625% of risk weighted assets for 2016, 1.25% for 2017, 1.875% for 2018 and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers. Capital ratios shown for September 30, 2016 are in excess of the Basel III 2016 phase-in level for the capital conservation buffer.

As of September 30, 2016, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category.

The following table sets forth certain information concerning the Bank's regulatory capital as of the dates presented:

| (Dollar amounts in thousands)                         | September 30, 2016 |         | December 31, 2015 |         |
|-------------------------------------------------------|--------------------|---------|-------------------|---------|
|                                                       | Amount             | Ratio   | Amount            | Ratio   |
| Total capital to risk-weighted assets:                |                    |         |                   |         |
| Actual                                                | \$ 58,124          | 12.68 % | \$ 56,090         | 13.99 % |
| For capital adequacy purposes                         | 36,665             | 8.00 %  | 32,070            | 8.00 %  |
| To be well capitalized                                | 45,832             | 10.00 % | 40,087            | 10.00 % |
| Tier 1 capital to risk-weighted assets:               |                    |         |                   |         |
| Actual                                                | \$ 52,606          | 11.48 % | \$ 51,073         | 12.74 % |
| For capital adequacy purposes                         | 27,499             | 6.00 %  | 24,052            | 6.00 %  |
| To be well capitalized                                | 36,665             | 8.00 %  | 32,070            | 8.00 %  |
| Common Equity Tier 1 capital to risk-weighted assets: |                    |         |                   |         |

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|                                   |           |       |   |           |       |   |
|-----------------------------------|-----------|-------|---|-----------|-------|---|
| Actual                            | \$ 52,606 | 11.48 | % | \$ 51,073 | 12.74 | % |
| For capital adequacy purposes     | 20,624    | 4.50  | % | 18,039    | 4.50  | % |
| To be well capitalized            | 29,791    | 6.50  | % | 26,057    | 6.50  | % |
| Tier 1 capital to average assets: |           |       |   |           |       |   |
| Actual                            | \$ 52,606 | 7.69  | % | \$ 51,073 | 8.83  | % |
| For capital adequacy purposes     | 27,361    | 4.00  | % | 23,131    | 4.00  | % |
| To be well capitalized            | 34,201    | 5.00  | % | 28,914    | 5.00  | % |

**12. Accumulated Other Comprehensive Income (Loss)**

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the three months ended September 30, 2016 and 2015 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)                                           | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|-------------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income (Loss) at July 1, 2016           | \$ 1,038                                                              | \$(3,514)                              | \$(2,476) |
| Other comprehensive income before reclassification                      | (179)                                                                 | )                                      | (179 )    |
| Amounts reclassified from accumulated other comprehensive income (loss) | -                                                                     | -                                      | -         |
| Net current period other comprehensive income                           | (179)                                                                 | )                                      | (179 )    |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2016     | \$ 859                                                                | \$(3,514)                              | \$(2,655) |

| (Dollar amounts in thousands)                                      | Amount<br>Reclassified<br>from Accumulated<br>Other<br>Comprehensive<br>Income<br>For the three<br>months<br>ended September<br>30, 2016 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                                          |                                                                         |
| Unrealized gains and losses on available-for-sale securities       | \$ -                                                                                                                                     | Net gain on sale of available-for-sale securities                       |
|                                                                    | -                                                                                                                                        | Provision for income taxes                                              |
| Total reclassifications for the period                             | \$ -                                                                                                                                     | Net of tax                                                              |

| (Dollar amounts in thousands)                                 | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|---------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income (Loss) at July 1, 2015 | \$ 32                                                                 | \$(3,196)                              | \$(3,164) |

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|                                                                         |        |           |           |
|-------------------------------------------------------------------------|--------|-----------|-----------|
| Other comprehensive income before reclassification                      | 792    | -         | 792       |
| Amounts reclassified from accumulated other comprehensive income (loss) | (352)  | ) -       | (352 )    |
| Net current period other comprehensive income                           | 440    | -         | 440       |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2015     | \$ 472 | \$(3,196) | \$(2,724) |

| (Dollar amounts in thousands)                                    | Amount Reclassified<br>from Accumulated<br>Other<br>Comprehensive<br>Income<br>For the three months<br>ended September 30,<br>2015 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Loss Components |                                                                                                                                    |                                                                         |
| Unrealized gains and losses on available-for-sale<br>securities  | \$ 533                                                                                                                             | Net gain on sale of available-for-sale<br>securities                    |
|                                                                  | (181)                                                                                                                              | ) Provision for income taxes                                            |
| Total reclassifications for the period                           | \$ 352                                                                                                                             | Net of tax                                                              |

**12. Accumulated Other Comprehensive Income (Loss) (continued)**

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the nine months ended September 30, 2016 and 2015 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)                                           | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|-------------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income (Loss) at January 1, 2016        | \$ (248                                                               | ) \$(3,514)                            | \$(3,762) |
| Other comprehensive income before reclassification                      | 1,162                                                                 | -                                      | 1,162     |
| Amounts reclassified from accumulated other comprehensive income (loss) | (55                                                                   | ) -                                    | (55 )     |
| Net current period other comprehensive income                           | 1,107                                                                 | -                                      | 1,107     |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2016     | \$ 859                                                                | \$(3,514)                              | \$(2,655) |

| (Dollar amounts in thousands)                                      | Amount<br>Reclassified<br>from Accumulated<br>Other<br>Comprehensive<br>Income<br>For the nine months<br>ended September<br>30, 2016 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                                      |                                                                         |
| Unrealized gains and losses on available-for-sale securities       | \$ 83                                                                                                                                | Net gain on sale of available-for-sale securities                       |
| Total reclassifications for the period                             | \$ (28                                                                                                                               | ) Provision for income taxes<br>Net of tax                              |

| (Dollar amounts in thousands)                                    | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income (Loss) at January 1, 2015 | \$ 198                                                                | \$(3,196)                              | \$(2,998) |
| Other comprehensive income before reclassification               | 648                                                                   | -                                      | 648       |



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|                                                                         |        |   |           |           |   |
|-------------------------------------------------------------------------|--------|---|-----------|-----------|---|
| Amounts reclassified from accumulated other comprehensive income (loss) | (374   | ) | -         | (374      | ) |
| Net current period other comprehensive income                           | 274    |   | -         | 274       |   |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2015     | \$ 472 |   | \$(3,196) | \$(2,724) |   |

| (Dollar amounts in thousands)                                      | Amount<br>Reclassified<br>from Accumulated<br>Other<br>Comprehensive<br>Income<br>For the nine months<br>ended September<br>30, 2015 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                                      |                                                                         |
| Unrealized gains and losses on available-for-sale<br>securities    | \$ 567                                                                                                                               | Net gain on sale of available-for-sale<br>securities                    |
| Total reclassifications for the period                             | \$ 374                                                                                                                               | ) Provision for income taxes<br>Net of tax                              |

### 13. New Accounting Standards

In May 2014, the Financial Accounting Standard Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, "*Revenue from Contracts with Customers*." The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update will become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. In evaluating this standard, management has determined that the majority of revenue earned by the Company are from revenue streams not included in the scope of this standard and thus no material impact is expected with the adoption of this standard.

In January 2016, the FASB issued ASU 2016-01, "*Recognition and Measurement of Financial Assets and Financial Liabilities*." This ASU requires that all equity investments be measured at fair value with changes in the fair value to be recognized through net income unless accounted for under the equity method of accounting or those that result in consolidation of the investee. This ASU also requires that an entity present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. In addition, this ASU eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities and the requirement to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet for public business entities. This ASU is effective for annual periods beginning after December 15, 2017, and interim periods therein. The Company is evaluating the impact of this ASU on its financial statements and disclosures.

In February 2016, the FASB issued ASU 2016-02, "*Leases*." This ASU requires lessees to record most leases on their balance sheet but recognize expenses in the income statement in a manner similar to current accounting treatment. This ASU changes the guidance on sale-leaseback transactions, initial direct costs and lease execution costs, and, for lessors, modifies the classification criteria and the accounting for sales-type and direct financing leases. This ASU is effective for annual periods beginning after December 15, 2018, and interim periods therein. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company is evaluating the impact of this ASU on its financial statements and disclosures.

In March 2016, the FASB issued ASU 2016-09, *“Improvements to Employee Share-Based Payment Accounting.”* This ASU simplifies certain aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods therein. The Company does not expect this ASU to have a material impact on its financial statements and disclosures.

### **13. New Accounting Standards (continued)**

In June 2016, the FASB issued ASU 2016-13, “*Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.*” This ASU significantly changes the way impairment of financial instruments is recognized by requiring immediate recognition of estimated credit losses expected to occur over the remaining life of the financial instruments. The main provisions of the guidance include (1) replacing the “incurred loss” approach under current GAAP with an “expected loss” model for instruments measured at amortized cost, (2) requiring entities to record an allowance for available-for-sale debt securities rather than reduce the carrying amount of the investments, as is required by the other-than-temporary impairment model under current GAAP, and (3) a simplified accounting model for purchased credit-impaired debt securities and loans. The ASU is effective for interim and annual reporting periods beginning after December 15, 2019, although early adoption is permitted. The Company is evaluating the impact of this ASU on its financial statements and disclosures.

In August 2016, the FASB issued ASU 2016-15, “*Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force)*”. This ASU clarifies the presentation of specific types of cash flow receipts and payments, including the payment of debt prepayment or debt extinguishment costs, contingent consideration cash payments paid subsequent to the acquisition date and proceeds from settlement of BOLI policies. This guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and is to be applied under a retrospective approach, if practicable. The Company is evaluating the impact of this ASU on its financial statements and disclosures.

### **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

This section discusses the consolidated financial condition and results of operations of Emclaire Financial Corp and its wholly owned subsidiaries for the three and nine months ended September 30, 2016, compared to the same periods in 2015 and should be read in conjunction with the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 29 of this Form 10-Q.

This Form 10-Q, including the financial statements and related notes, contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, objectives, expected operating results and the assumptions upon which those statements are based. Forward looking statements include without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and are typically identified with words such as “may,” “could,” “should,” “will,” “would,” “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan” or words or phrases of similar meaning. We caution that the forward looking statements are based largely on our expectations and are subject to a number of

known and unknown risks and uncertainties that are subject to change based on factors which are, in many instances, beyond our control. Actual results, performances or achievements could differ materially from those contemplated, expressed or implied by the forward looking statements. Therefore, we caution you not to place undue reliance on our forward looking information and statements. Except as required by applicable law or regulation, we will not update the forward looking statements to reflect actual results or changes in factors affecting the forward looking statements.

## CHANGES IN FINANCIAL CONDITION

Total assets increased \$93.1 million, or 15.5%, to \$693.7 million at September 30, 2016 from \$600.6 million at December 31, 2015. This increase resulted primarily from an increase in cash and equivalents and loans receivable of \$15.3 million and \$78.3 million, respectively. Total liabilities increased \$90.7 million, or 16.6%, to \$638.5 million at September 30, 2016 from \$547.8 million at December 31, 2015, resulting primarily from a \$102.7 million increase in customer deposits, partially offset by a \$12.0 million decrease in borrowed funds. Deposit growth consisted of a \$98.4 million, or 26.6%, increase in interest bearing deposits and a \$4.4 million, or 3.6%, increase in noninterest-bearing deposits. The increases in the assets and liabilities of the Corporation were primarily driven by the April 30, 2016 acquisition of United American Savings Bank (United American). The acquisition added \$66.1 million in loans receivable and \$72.7 million in customer deposits. In connection with the acquisition, the Corporation recorded goodwill of \$6.6 million and a core deposit intangible of \$232,000. For more information regarding the acquisition, see Note 2 to the Corporation's consolidated financial statements for September 30, 2016 included in Item 1 hereto.

Stockholders' equity increased \$2.4 million, or 4.5%, to \$55.2 million at September 30, 2016 from \$52.8 million at December 31, 2015. Book value per common share was \$25.73 at September 30, 2016, compared to \$24.64 at December 31, 2015.

At September 30, 2016, the Bank was considered "well-capitalized" with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.69%, 11.48%, 11.48% and 12.68%, respectively. The Bank was also considered "well-capitalized" at December 31, 2015 with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.83%, 12.74%, 12.74% and 13.99%, respectively. The decrease in the capital ratios between the two respective periods occurred as the Bank's average assets increased following the United American acquisition.

## RESULTS OF OPERATIONS

### Comparison of Results for the Three Months Ended September 30, 2016 and 2015

**General.** Net income decreased \$462,000, or 30.4%, to \$1.1 million for the three months ended September 30, 2016 from \$1.5 million for the same period in 2015. This decrease was the result of a decrease in noninterest income of \$367,000, and increases in the provision for loans losses and noninterest expense of \$270,000 and \$567,000, respectively, partially offset by an increase in net interest income of \$579,000 and a decrease in the provision for income taxes of \$163,000.

**Net interest income.** Tax equivalent net interest income increased \$555,000, or 12.1%, to \$5.2 million for the three months ended September 30, 2016 from \$4.6 million for the three months ended September 30, 2015. This increase was attributed to an increase in tax equivalent interest income of \$957,000, partially offset by an increase in interest expense of \$402,000.

**Interest income.** Tax equivalent interest income increased \$957,000, or 18.1%, to \$6.2 million for the three months ended September 30, 2016 from \$5.3 million for the same period in 2015. This increase was attributed to increases in interest earned on loans and interest earning deposits with banks and dividends on federal bank stocks of \$1.1 million, \$33,000 and \$19,000, respectively, partially offset by a decreases in interest earned on securities of \$155,000.

Tax equivalent interest earned on loans receivable increased \$1.1 million, or 23.7%, to \$5.5 million for the three months ended September 30, 2016 compared to \$4.5 million for the same period in 2015. This increase resulted from a \$103.0 million, or 25.5% increase in average loans, accounting for an increase of \$1.1 million in interest income. The increase in loans receivable was primarily related to the acquisition of United American in April 2016. Partially offsetting this favorable volume variance, the average yield on loans decreased 5 basis points to 4.35% for the three months ended September 30, 2016, versus 4.40% for the same period in 2015. This unfavorable yield variance accounted for a \$67,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$155,000, or 20.2%, to \$612,000 for the three months ended September 30, 2016 compared to \$767,000 for the three months ended September 30, 2015. This decrease resulted from a \$33.6 million, or 24.4%, decrease in the average balance of securities, accounting for a \$196,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 13 basis points to 2.34% for the three months ended September 30, 2016 versus 2.21% for the same period in 2015. This favorable yield variance accounted for a \$41,000 increase in interest income.

Interest earned on deposits with banks increased \$33,000 to \$48,000 for the three months ended September 30, 2016 compared to \$15,000 for the three months ended September 30, 2015. This increase resulted from a \$24.0 million increase in the average balance of interest-earning deposits, accounting for an increase of \$32,000 in interest income. The average yield on these accounts increased 4 basis points to 0.53% for the three months ended September 30, 2016, versus 0.49% for the same period in 2015, accounting for a \$1,000 increase in interest income.

Dividends on federal bank stocks increased \$19,000, or 63.3%, to \$49,000 for the three months ended September 30, 2016 from \$30,000 for the same period in 2015. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.3 million, or 52.7%, to \$3.8 million compared to \$2.5 million for the same period in 2015, accounting for a \$17,000 increase in interest income. Additionally, the average yield on these assets increased 34 basis points to 5.14% for the three months ended September 30, 2016, versus 4.80% for the same period in 2015, accounting for a \$2,000 increase in interest income.

**Interest expense.** Interest expense increased \$402,000, or 58.5%, to \$1.1 million for the three months ended September 30, 2016 from \$687,000 for the same period in 2015. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$249,000 and \$153,000, respectively.

Interest expense incurred on deposits increased \$249,000, or 46.8%, to \$781,000 for the three months ended September 30, 2016 compared to \$532,000 for the same period in 2015. The average balance of interest-bearing deposits increased \$83.1 million, or 21.4%, to \$470.7 million for the three months ended September 30, 2016, compared to \$387.6 million for the same period in 2015 causing a \$126,000 increase in interest expense. This increase was primarily due to the acquisition of United American in April 2016. Additionally, the average cost of interest-bearing deposits increased 12 basis points to 0.66% for the three months ended September 30, 2016, compared to 0.54% for the same period in 2015, resulting in a \$123,000 increase in interest expense.

Interest expense incurred on borrowed funds increased \$153,000, or 98.7%, to \$308,000 for the three months ended September 30, 2016, compared to \$155,000 for the same period in the prior year. The average balance of borrowed funds increased \$16.7 million, or 81.3%, to \$37.3 million for the three months ended September 30, 2016, compared to \$20.5 million for the same period in 2015 causing a \$122,000 increase in interest expense. Additionally, the average cost of borrowed funds increased 30 basis points, or 10.0%, to 3.29% for the three months ended September



30, 2016 compared to 2.99% for the same period in 2015 causing a \$31,000 increase in interest expense.

**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average loan balances include nonaccrual loans and exclude the allowance for loan losses and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt loans and securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis. The information is based on average daily balances during the periods presented.

| (Dollar amounts in thousands)           | Three months ended September 30, |          |                    |                    |          |                    |
|-----------------------------------------|----------------------------------|----------|--------------------|--------------------|----------|--------------------|
|                                         | 2016                             |          |                    | 2015               |          |                    |
|                                         | Average<br>Balance               | Interest | Yield<br>/<br>Rate | Average<br>Balance | Interest | Yield<br>/<br>Rate |
| <b>Interest-earning assets:</b>         |                                  |          |                    |                    |          |                    |
| Loans, taxable                          | \$480,450                        | \$5,232  | 4.33 %             | \$378,657          | \$4,170  | 4.37 %             |
| Loans, tax exempt                       | 25,887                           | 301      | 4.63 %             | 24,672             | 303      | 4.88 %             |
| Total loans receivable                  | 506,337                          | 5,533    | 4.35 %             | 403,329            | 4,473    | 4.40 %             |
| Securities, taxable                     | 75,493                           | 396      | 2.09 %             | 105,071            | 481      | 1.82 %             |
| Securities, tax exempt                  | 28,518                           | 216      | 3.01 %             | 32,582             | 286      | 3.48 %             |
| Total securities                        | 104,011                          | 612      | 2.34 %             | 137,653            | 767      | 2.21 %             |
| Interest-earning deposits with banks    | 36,203                           | 48       | 0.53 %             | 12,252             | 15       | 0.49 %             |
| Federal bank stocks                     | 3,789                            | 49       | 5.14 %             | 2,481              | 30       | 4.80 %             |
| Total interest-earning cash equivalents | 39,992                           | 97       | 0.96 %             | 14,733             | 45       | 1.21 %             |
| Total interest-earning assets           | 650,340                          | 6,242    | 3.82 %             | 555,715            | 5,285    | 3.77 %             |
| Cash and due from banks                 | 2,730                            |          |                    | 2,524              |          |                    |
| Other noninterest-earning assets        | 44,840                           |          |                    | 35,658             |          |                    |
| Total Assets                            | \$697,910                        |          |                    | \$593,897          |          |                    |
| <b>Interest-bearing liabilities:</b>    |                                  |          |                    |                    |          |                    |
| Interest-bearing demand deposits        | \$298,031                        | \$157    | 0.21 %             | \$268,979          | \$100    | 0.15 %             |
| Time deposits                           | 172,627                          | 624      | 1.44 %             | 118,625            | 432      | 1.44 %             |
| Total interest-bearing deposits         | 470,658                          | 781      | 0.66 %             | 387,604            | 532      | 0.54 %             |
| Borrowed funds, short-term              | 2,500                            | 27       | 4.28 %             | 5,541              | 5        | 0.36 %             |
| Borrowed funds, long-term               | 34,750                           | 281      | 3.22 %             | 15,000             | 150      | 3.97 %             |
| Total borrowed funds                    | 37,250                           | 308      | 3.29 %             | 20,541             | 155      | 2.99 %             |
| Total interest-bearing liabilities      | 507,908                          | 1,089    | 0.85 %             | 408,145            | 687      | 0.67 %             |

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|                                                                                                                                    |           |         |        |           |         |        |
|------------------------------------------------------------------------------------------------------------------------------------|-----------|---------|--------|-----------|---------|--------|
| Noninterest-bearing demand deposits                                                                                                | 125,965   | -       | -      | 120,586   | -       | -      |
| Funding and cost of funds                                                                                                          | 633,873   | 1,089   | 0.68 % | 528,731   | 687     | 0.52 % |
| Other noninterest-bearing liabilities                                                                                              | 8,929     |         |        | 7,750     |         |        |
| Total Liabilities                                                                                                                  | 642,802   |         |        | 536,481   |         |        |
| Stockholders' Equity                                                                                                               | 55,108    |         |        | 57,416    |         |        |
| Total Liabilities and Stockholders' Equity                                                                                         | \$697,910 |         |        | \$593,897 |         |        |
| Net interest income                                                                                                                |           | \$5,153 |        |           | \$4,598 |        |
| <b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) |           |         | 2.97 % |           |         | 3.11 % |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                       |           |         | 3.15 % |           |         | 3.28 % |

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Corporation's interest income and interest expense are attributable to changes in volume (changes in volume multiplied by prior year rate), rate (change in rate multiplied by prior year volume) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on loans and securities reflect the changes in interest income on a fully tax equivalent basis.

| (Dollar amounts in thousands)          | Three months ended September 30,<br>2016 versus 2015 |               |            |
|----------------------------------------|------------------------------------------------------|---------------|------------|
|                                        | Increase (Decrease) due to                           |               |            |
|                                        | Volume                                               | Rate          | Total      |
| Interest income:                       |                                                      |               |            |
| Loans                                  | \$ 1,127                                             | \$ (67 )      | \$ 1,060   |
| Securities                             | (196 )                                               | 41            | (155 )     |
| Interest-earning deposits with banks   | 32                                                   | 1             | 33         |
| Federal bank stocks                    | 17                                                   | 2             | 19         |
| <br>Total interest-earning assets      | <br>980                                              | <br>(23 )     | <br>957    |
| Interest expense:                      |                                                      |               |            |
| Interest-bearing deposits              | 126                                                  | 123           | 249        |
| Borrowed funds, short-term             | 2                                                    | 78            | 80         |
| Borrowed funds, long-term              | 120                                                  | (47 )         | 73         |
| <br>Total interest-bearing liabilities | <br>248                                              | <br>154       | <br>402    |
| <br>Net interest income                | <br>\$ 732                                           | <br>\$ (177 ) | <br>\$ 555 |

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of nonperforming assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

Information pertaining to the allowance for loan losses and nonperforming assets for the three months ended September 30, 2016 and 2015 is as follows:

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| (Dollar amounts in thousands)                     | As of or for the three months ended |   |          |   |
|---------------------------------------------------|-------------------------------------|---|----------|---|
|                                                   | September 30,                       |   |          |   |
|                                                   | 2016                                |   | 2015     |   |
| Balance at the beginning of the period            | \$ 5,431                            |   | \$ 5,370 |   |
| Provision for (recovery of) loan losses           | 168                                 |   | (102)    | ) |
| Charge-offs                                       | (94)                                | ) | (209)    | ) |
| Recoveries                                        | 9                                   |   | 20       |   |
| Balance at the end of the period                  | \$ 5,514                            |   | \$ 5,079 |   |
| Non-performing loans                              | \$ 3,327                            |   | \$ 5,032 |   |
| Non-performing assets                             | 3,508                               |   | 5,199    |   |
| Non-performing loans to total loans               | 0.65                                | % | 1.22     | % |
| Non-performing assets to total assets             | 0.51                                | % | 0.89     | % |
| Allowance for loan losses to total loans          | 1.07                                | % | 1.24     | % |
| Allowance for loan losses to non-performing loans | 165.73                              | % | 100.93   | % |

Nonperforming loans remained stable at \$3.3 million at September 30, 2016 and June 30, 2016. Of the \$3.3 million in nonperforming loans, \$1.3 million were not past due at September 30, 2016.

As of September 30, 2016, the Corporation's classified and criticized assets amounted to \$14.8 million, or 2.1% of total assets, with \$9.7 million classified as substandard and \$5.1 million identified as special mention. This compares to classified and criticized assets of \$12.8 million, or 1.8% of total assets, with \$7.3 million classified as substandard and \$5.5 million identified as special mention at June 30, 2016. This increase was related to a commercial loan relationship consisting of two loans totaling \$2.6 million being classified as substandard during the quarter ended September 30, 2016.

The provision for loan losses increased \$270,000 to \$168,000 for the three months ended September 30, 2016 from a \$102,000 recovery for the same period in the prior year. The provision for loan losses recorded in the third quarter of 2016 reflects a level of expense that is typically experienced by the Corporation. The \$102,000 recovery recognized during the third quarter of 2015 resulted from a general improvement in economic factors and historical loss ratios of the overall loan portfolio and the improvement of two large commercial loan relationships which previously had substantial specific reserves allocated.

**Noninterest income.** Noninterest income decreased \$367,000, or 26.6%, to \$1.0 million for the three months ended September 30, 2016, compared to \$1.4 million for the same period in the prior year. This decrease resulted primarily from a \$533,000 decrease in net gains on the sale of securities. During the three months ended September 30, 2015, the Corporation sold certain securities to accommodate loan production and generated \$533,000 of net gains. During the three months ended September 30, 2016, the Corporation did not realize any securities gains, but did recognize \$121,000 in gains on loans sold to the Federal Home Loan Bank of Pittsburgh (FHLB).

**Noninterest expense.** Noninterest expense increased \$567,000, or 14.4%, to \$4.5 million for the three months ended September 30, 2016 compared to \$3.9 million for the same period in 2015. This increase in noninterest expense can be attributed to increases in compensation and benefits, premises and equipment, federal deposit insurance, and other noninterest expense of \$256,000, \$86,000, \$31,000 and \$192,000, respectively.

Compensation and employee benefits expense increased \$256,000, or 12.8%, to \$2.3 million for the three months ended September 30, 2016 compared to \$2.0 million for the same period in the prior year. This increase was primarily the result of increases in salaries, insurance benefits, payroll taxes and retirement benefits of \$172,000, \$32,000, \$15,000 and \$13,000, respectively. The increases in compensation and employee benefits related expenses were due primarily to the addition of the branch office in the United American acquisition in April 2016 and the opening of the new Aspinwall branch office in August 2016.

Premises and equipment expense increased \$86,000, or 13.3%, to \$732,000 for the three months ended September 30, 2016 compared to \$646,000 for the same period in the prior year. This increase was primarily the result of the two new branch offices which added \$76,000 of expense for the quarter ended September 30, 2016.

Other noninterest expense increased \$192,000, or 20.1%, to \$1.1 million for the three months ended September 30, 2016 compared to \$956,000 for the same period in the prior year. Contributing to the increase were operating costs of \$85,000 associated with the two new branch offices and increased technology related costs.

The Corporation recognized \$60,000 of core deposit intangible amortization expense during the third quarter of 2016 compared to \$49,000 for the same period in 2015. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the “Notes to Consolidated Financial Statements” beginning on page 6.

**Provision for income taxes.** The provision for income taxes decreased \$163,000, or 35.4%, to \$297,000 for the three months ended September 30, 2016 compared to \$460,000 for the same period in the prior year. This decrease was driven by the decrease in taxable income coupled with a decrease in the Corporation’s effective tax rate to 21.9% for the three months ended September 30, 2016 compared to 23.2% for the same period in the prior year.

Comparison of Results for the Nine Months Ended September 30, 2016 and 2015

**General.** Net income decreased \$439,000, or 13.6%, to \$2.8 million for the nine months ended September 30, 2016 from \$3.2 million for the same period in 2015. This decrease was the result of a decrease in noninterest income of \$272,000, and increases in the provision for loans losses and noninterest expense of \$201,000 and \$1.1 million, respectively, partially offset by an increase in net interest income of \$1.1 million.

**Net interest income.** Tax equivalent net interest income increased \$1.0 million, or 7.5%, to \$14.8 million for the nine months ended September 30, 2016 from \$13.8 million for the nine months ended September 30, 2015. This increase can be attributed to an increase in tax equivalent interest income of \$1.8 million, partially offset by an increase in interest expense of \$811,000.

**Interest income.** Tax equivalent interest income increased \$1.8 million, or 11.6%, to \$17.8 million for the nine months ended September 30, 2016 from \$15.9 million for the same period in 2015. This increase can be attributed to increases in interest earned on loans and interest earning deposits with banks and dividends on federal bank stocks of \$2.3 million, \$60,000 and \$3,000, respectively, partially offset by a decrease in interest earned on securities of \$498,000.

Tax equivalent interest earned on loans receivable increased \$2.3 million, or 17.1%, to \$15.6 million for the nine months ended September 30, 2016 compared to \$13.3 million for the same period in 2015. This increase resulted from a \$80.4 million, or 20.4% increase in average loans, accounting for an increase of \$2.6 million in interest income. The increase resulted from strong loan growth during late of 2015 and the first three quarters of 2016 and the acquisition of United American in April 2016. Partially offsetting this favorable volume variance, the average yield on loans decreased 13 basis points to 4.39% for the nine months ended September 30, 2016, versus 4.52% for the same period in 2015. This unfavorable yield variance accounted for a \$370,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$498,000, or 20.6%, to \$1.9 million for the nine months ended September 30, 2016 compared to \$2.4 million for the nine months ended September 30, 2015. This decrease resulted from a \$36.8 million, or 25.2%, decrease in the average balance of securities, accounting for a \$641,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 14 basis points to 2.36% for the nine months ended September 30, 2016 versus 2.22% for the same period in 2015. This favorable yield variance accounted for a \$143,000 increase in interest income.

Interest earned on deposits with banks increased \$60,000 to \$110,000 for the nine months ended September 30, 2016 compared to \$50,000 for the nine months ended September 30, 2015. This increase resulted from a \$14.8 million



increase in the average balance of interest-earning deposits, accounting for an increase of \$59,000 in interest income. The average yield on these accounts increased 1 basis point to 0.53% for the nine months ended September 30, 2016, versus 0.52% for the same period in 2015, accounting for a \$1,000 increase in interest income.

Dividends on federal bank stocks increased \$3,000, or 2.3%, to \$135,000 for the nine months ended September 30, 2016 from \$132,000 for the same period in 2015. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.3 million, or 54.2%, to \$3.6 million compared to \$2.3 million for the same period in 2015, accounting for a \$57,000 increase in interest income. This favorable variance was partially offset by a one-time special dividend paid in the first quarter of 2015 by the Federal Home Loan Bank of Pittsburgh.

Interest expense. Interest expense increased \$811,000, or 38.1%, to \$2.9 million for the nine months ended September 30, 2016 from \$2.1 million for the same period in 2015. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$478,000 and \$333,000, respectively.

Interest expense incurred on deposits increased \$478,000, or 29.6%, to \$2.1 million for the nine months ended September 30, 2016 compared to \$1.6 million for the same period in 2015. The average cost of interest-bearing deposits increased 9 basis points to 0.64% for the nine months ended September 30, 2016, compared to 0.55% for the same period in 2015, resulting in a \$292,000 increase in interest expense. Additionally, the average balance of interest-bearing deposits increased \$42.7 million, or 10.8%, to \$436.6 million for the nine months ended September 30, 2016, compared to \$393.9 million for the same period in 2015 causing a \$186,000 increase in interest expense. In addition, average noninterest bearing deposits increased \$4.5 million, or 3.8%, to \$122.1 million from \$117.6 million.

Interest expense incurred on borrowed funds increased \$333,000, or 64.8%, to \$847,000 for the nine months ended September 30, 2016, compared to \$514,000 for the same period in the prior year. The average balance of borrowed funds increased \$17.5 million, or 88.4%, to \$37.3 million for the nine months ended September 30, 2016, compared to \$19.8 million for the same period in 2015 causing a \$405,000 increase in interest expense. Partially offsetting this unfavorable variance, the average cost of borrowed funds decreased 44 basis points, or 12.6%, to 3.04% for the nine months ended September 30, 2016 compared to 3.48% for the same period in 2015 causing a \$72,000 decrease in interest expense.

**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average loan balances include nonaccrual loans and exclude the allowance for loan losses and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt loans and securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis. The information is based on average daily balances during the periods presented.

| (Dollar amounts in thousands)           | Nine months ended September 30, |          |              |                 |          |              |
|-----------------------------------------|---------------------------------|----------|--------------|-----------------|----------|--------------|
|                                         | 2016                            |          |              | 2015            |          |              |
|                                         | Average Balance                 | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate |
| <b>Interest-earning assets:</b>         |                                 |          |              |                 |          |              |
| Loans, taxable                          | \$448,711                       | \$14,685 | 4.37 %       | \$369,508       | \$12,407 | 4.49 %       |
| Loans, tax exempt                       | 26,228                          | 920      | 4.69 %       | 25,061          | 919      | 4.90 %       |
| Total loans receivable                  | 474,939                         | 15,605   | 4.39 %       | 394,569         | 13,326   | 4.52 %       |
| Securities, taxable                     | 80,409                          | 1,270    | 2.11 %       | 112,991         | 1,525    | 1.80 %       |
| Securities, tax exempt                  | 28,587                          | 652      | 3.05 %       | 32,797          | 895      | 3.65 %       |
| Total securities                        | 108,996                         | 1,922    | 2.36 %       | 145,788         | 2,420    | 2.22 %       |
| Interest-earning deposits with banks    | 27,805                          | 110      | 0.53 %       | 12,971          | 50       | 0.52 %       |
| Federal bank stocks                     | 3,608                           | 135      | 5.00 %       | 2,340           | 132      | 7.54 %       |
| Total interest-earning cash equivalents | 31,413                          | 245      | 1.04 %       | 15,311          | 182      | 1.59 %       |
| Total interest-earning assets           | 615,348                         | 17,772   | 3.86 %       | 555,668         | 15,928   | 3.83 %       |
| Cash and due from banks                 | 2,537                           |          |              | 2,444           |          |              |
| Other noninterest-earning assets        | 41,120                          |          |              | 33,895          |          |              |
| Total Assets                            | \$659,005                       |          |              | \$592,007       |          |              |
| <b>Interest-bearing liabilities:</b>    |                                 |          |              |                 |          |              |
| Interest-bearing demand deposits        | \$286,339                       | \$442    | 0.21 %       | \$274,186       | \$309    | 0.15 %       |
| Time deposits                           | 150,243                         | 1,649    | 1.47 %       | 119,691         | 1,304    | 1.46 %       |
| Total interest-bearing deposits         | 436,582                         | 2,091    | 0.64 %       | 393,877         | 1,613    | 0.55 %       |
| Borrowed funds, short-term              | 1,925                           | 48       | 3.35 %       | 4,783           | 65       | 1.81 %       |
| Borrowed funds, long-term               | 35,354                          | 799      | 3.02 %       | 15,000          | 449      | 4.01 %       |
| Total borrowed funds                    | 37,279                          | 847      | 3.04 %       | 19,783          | 514      | 3.48 %       |
| Total interest-bearing liabilities      | 473,861                         | 2,938    | 0.83 %       | 413,660         | 2,127    | 0.69 %       |
| Noninterest-bearing demand deposits     | 122,133                         | -        | -            | 117,628         | -        | -            |

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|                                                                                                                             |           |          |        |           |          |        |
|-----------------------------------------------------------------------------------------------------------------------------|-----------|----------|--------|-----------|----------|--------|
| Funding and cost of funds                                                                                                   | 595,994   | 2,938    | 0.66 % | 531,288   | 2,127    | 0.54 % |
| Other noninterest-bearing liabilities                                                                                       | 8,731     |          |        | 8,324     |          |        |
| Total Liabilities                                                                                                           | 604,725   |          |        | 539,612   |          |        |
| Stockholders' Equity                                                                                                        | 54,280    |          |        | 52,395    |          |        |
| Total Liabilities and Stockholders' Equity                                                                                  | \$659,005 |          |        | \$592,007 |          |        |
| Net interest income                                                                                                         |           | \$14,834 |        |           | \$13,801 |        |
| Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) |           |          | 3.03 % |           |          | 3.15 % |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                |           |          | 3.22 % |           |          | 3.32 % |

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Corporation's interest income and interest expense are attributable to changes in volume (changes in volume multiplied by prior year rate), rate (change in rate multiplied by prior year volume) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on loans and securities reflect the changes in interest income on a fully tax equivalent basis.

| (Dollar amounts in thousands)        | Nine months ended September 30,<br>2016 versus 2015 |           |          |
|--------------------------------------|-----------------------------------------------------|-----------|----------|
|                                      | Increase (Decrease) due to                          |           |          |
|                                      | Volume                                              | Rate      | Total    |
| <b>Interest income:</b>              |                                                     |           |          |
| Loans                                | \$ 2,649                                            | \$ (370 ) | \$ 2,279 |
| Securities                           | (641 )                                              | 143       | (498 )   |
| Interest-earning deposits with banks | 59                                                  | 1         | 60       |
| Federal bank stocks                  | 57                                                  | (54 )     | 3        |
| <br>                                 |                                                     |           |          |
| Total interest-earning assets        | 2,124                                               | (280 )    | 1,844    |
| <br>                                 |                                                     |           |          |
| <b>Interest expense:</b>             |                                                     |           |          |
| Interest-bearing deposits            | 186                                                 | 292       | 478      |
| Borrowed funds, short-term           | (1 )                                                | 85        | 84       |
| Borrowed funds, long-term            | 406                                                 | (157 )    | 249      |
| <br>                                 |                                                     |           |          |
| Total interest-bearing liabilities   | 591                                                 | 220       | 811      |
| <br>                                 |                                                     |           |          |
| Net interest income                  | \$ 1,533                                            | \$ (500 ) | \$ 1,033 |

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of nonperforming assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

Information pertaining to the allowance for loan losses and nonperforming assets for the nine months ended September 30, 2016 and 2015 is as follows:

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| (Dollar amounts in thousands)                     | As of or for the nine months ended |   |          |   |
|---------------------------------------------------|------------------------------------|---|----------|---|
|                                                   | September 30,                      |   |          |   |
|                                                   | 2016                               |   | 2015     |   |
| Balance at the beginning of the period            | \$ 5,205                           |   | \$ 5,224 |   |
| Provision for loan losses                         | 470                                |   | 269      |   |
| Charge-offs                                       | (182                               | ) | (509     | ) |
| Recoveries                                        | 21                                 |   | 95       |   |
| Balance at the end of the period                  | \$ 5,514                           |   | \$ 5,079 |   |
| Non-performing loans                              | \$ 3,327                           |   | \$ 5,032 |   |
| Non-performing assets                             | 3,508                              |   | 5,199    |   |
| Non-performing loans to total loans               | 0.65                               | % | 1.22     | % |
| Non-performing assets to total assets             | 0.51                               | % | 0.89     | % |
| Allowance for loan losses to total loans          | 1.07                               | % | 1.24     | % |
| Allowance for loan losses to non-performing loans | 165.73                             | % | 100.93   | % |

Nonperforming loans increased \$258,000 to \$3.3 million at September 30, 2016 from \$3.1 million at December 31, 2015. The increase in nonperforming loans was primarily due to a commercial real estate loan placed on nonaccrual status during the quarter ended March 31, 2016. Of the \$3.3 million in nonperforming loans, \$950,000 related to one commercial loan relationship and \$1.3 million were not past due at September 30, 2016.

As of September 30, 2016, the Corporation's classified and criticized assets amounted to \$14.8 million, or 2.1% of total assets, with \$9.7 million classified as substandard and \$5.1 million identified as special mention. This compares to classified and criticized assets of \$8.0 million, or 1.3% of total assets, with \$6.9 million classified as substandard and \$1.0 million identified as special mention at December 31, 2015. This increase was related to one commercial loan relationship consisting of three loans totaling \$5.0 million being identified as special mention during the quarter ended March 31, 2016 and one commercial loan relationship consisting of two loans totaling \$2.6 million being classified as substandard during the quarter ended September 30, 2016.

The provision for loan losses increased \$201,000, or 74.7%, to \$470,000 for the nine months ended September 30, 2016 from \$269,000 for the same period in 2015. The provision for loan losses recorded for the nine months ended September 30, 2016 reflects a level of expense that is typically experienced by the Corporation. The lower level of provision for loan losses recorded during the same period in 2015 resulted from a \$102,000 recovery of loan losses recorded in the third quarter of 2015 following a general improvement in economic factors and historical loss ratios of the overall loan portfolio and the improvement of two large commercial loan relationships during the third quarter which previously had substantial specific reserves allocated.

**Noninterest income.** Noninterest income decreased \$367,000, or 26.6%, to \$1.0 million for the nine months ended September 30, 2016, compared to \$1.4 million for the same period in the prior year. This decrease primarily resulted from a \$533,000 decrease in net gains on the sale of securities. During the nine months ended September 30, 2016, the Corporation realized securities gains of \$83,000, of which \$81,000 related to a balance sheet management strategy whereby securities were sold to prepay a \$5.0 million FHLB long-term advance and the related securities gains were used to offset the impact of prepayment penalties associated with the early retirement of the advance. During the nine months ended September 30, 2015, the Corporation recorded securities gains of \$533,000 related to the sale of a securities to fund loan growth. Partially offsetting this decrease, the Corporation recognized \$121,000 in net gains on the sale of loans to the FHLB during the nine months ended September 30, 2016.

**Noninterest expense.** Noninterest expense increased \$1.1 million, or 9.0%, to \$13.0 million for the nine months ended September 30, 2016, compared to \$11.9 million for the same period in the prior year. This increase in noninterest expense can be attributed to increases in acquisition costs, compensation and benefits, other noninterest expense and premises and equipment of \$401,000, \$362,000, \$148,000 and \$140,000, respectively.

Costs related to the acquisition of United American totaled \$401,000 for the nine months ended September 30, 2016. These costs included legal fees, system conversion costs and other costs of \$194,000, \$132,000 and \$75,000, respectively.

Compensation and employee benefits expense increased \$362,000, or 5.9%, to \$6.5 million for the nine months ended September 30, 2016, compared to \$6.1 million for the same period in the prior year. This increase was primarily the result of increases in salaries, insurance benefits, payroll taxes and retirement benefits of \$269,000, \$54,000, \$35,000 and \$30,000, respectively, partially offset by a decrease in incentive expense of \$41,000. The increases in compensation and employee benefits related expenses were due primarily to the addition of the branch office in the United American acquisition in April 2016 and the opening of the new Aspinwall branch office in August 2016.

Premises and equipment expense increased \$140,000, or 7.1%, to \$2.1 million for the nine months ended September 30, 2016, compared to \$2.0 million for the same period in the prior year. This increase was primarily the result of the two new branch offices which added \$130,000 of expense for the nine months ended September 30, 2016.

Other noninterest expense increased \$148,000, or 5.3%, to \$3.0 million for the nine months ended September 30, 2016 compared to \$2.8 million for the same period in the prior year. Included in other noninterest expense for the nine months ended September 30, 2016 was a prepayment penalty of \$71,000 associated with the early retirement of an FHLB advance. Additionally, the two new branch offices added \$132,000 of expense for the nine months ended September 30, 2016.



The Corporation recognized \$165,000 of core deposit intangible amortization expense during the nine months of 2016 compared to \$146,000 for the same period in 2015. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American bank acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the “Notes to Consolidated Financial Statements” included in Item 1 hereto beginning on page 6.

**Provision for income taxes.** The provision for income taxes increased \$3,000 to \$880,000 for the nine months ended September 30, 2016 compared to \$877,000 for the same period in the prior year. The Corporation’s effective tax rate increased to 24.0% for the nine months ended September 30, 2016 compared to 21.4% for the same period in the prior year. The Corporation’s effective tax rate increased primarily due to certain non-deductible acquisition related expenses. This increase was offset by a decrease in the Corporation’s taxable income.

## LIQUIDITY

The Corporation’s primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB, Federal Reserve and other correspondent banks, and amortization and prepayments of outstanding loans and maturing securities. During the nine months ended September 30, 2016, the Corporation used its sources of funds primarily to fund loan purchases and advances and repay short term borrowed funds. As of September 30, 2016, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$78.3 million, and standby letters of credit totaling \$126,000.

At September 30, 2016, time deposits amounted to \$168.5 million, or 28.4% of the Corporation’s total consolidated deposits, including approximately \$51.5 million of which are scheduled to mature within the next year. Management of the Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve’s discount window. At September 30, 2016, the Corporation had borrowed funds of \$37.3 million consisting of \$30.0 million of long-term FHLB advances, a \$4.8 million long-term advance with a correspondent bank and \$2.5 million outstanding on a line of credit with a correspondent bank. At September 30, 2016, the Corporation’s borrowing capacity with the FHLB, net of funds borrowed and other commitments, was \$189.9 million.

Management is not aware of any conditions, including any regulatory recommendations or requirements, which would adversely impact its liquidity or its ability to meet funding needs in the ordinary course of business.

## **RECENT REGULATORY DEVELOPMENTS**

The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks were approved by the FRB and FDIC. Under the final rules, minimum requirements increased for both the quantity and quality of capital. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0% and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer comprised of common equity Tier 1 capital was also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, Total Capital and risk-weighted assets. The phase-in period for the final rules became effective on January 1, 2015 with full compliance with all of the final rules' requirements phased in over a multi-year schedule to be fully phased-in by January 1, 2019.

At September 30, 2016, the Bank exceeded all minimum capital requirements under these capital guidelines.

## CRITICAL ACCOUNTING POLICIES

The Corporation's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates or judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates or judgments. Certain policies inherently have a greater reliance on the use of estimates, and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates or judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques.

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015. These policies, along with the disclosures presented in the other financial statement notes provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies.

***Allowance for loan losses.*** The Corporation considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than its other significant accounting policies. The balance in the allowance for loan losses is determined based on management's review and evaluation of the loan portfolio in relation to past loss experience, the size and composition of the portfolio, current economic events and conditions and other pertinent factors, including management's assumptions as to delinquencies, recoveries and losses. All of these factors may be susceptible to significant change. Among the many factors affecting the allowance for loan losses, some are quantitative while others require qualitative judgment. Although management believes its process for determining the allowance adequately considers all of the potential factors that could potentially result in credit losses, the process includes subjective elements and may be susceptible to significant change. To the extent actual outcomes differ from management's estimates, additional provisions for loan losses may be required that would adversely impact the Corporation's financial condition or earnings in future periods.

***Other-than-temporary impairment.*** Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery.

***Goodwill and intangible assets.*** Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step is to determine the amount of the impairment. If the tests conclude that goodwill is impaired, the carrying value is adjusted and an impairment charge is recorded. As of November 30, 2015, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk for the Corporation consists primarily of interest rate risk exposure and liquidity risk. Since virtually all of the interest-earning assets and interest-bearing liabilities are at the Bank, virtually all of the interest rate risk and liquidity risk lies at the Bank level. The Bank is not subject to currency exchange risk or commodity price risk, and has no trading portfolio, and therefore, is not subject to any trading risk. In addition, the Bank does not participate in hedging transactions such as interest rate swaps and caps. Changes in interest rates will impact both income and expense recorded and also the market value of long-term interest-earning assets and interest-bearing liabilities. Interest rate risk and liquidity risk management is performed at the Bank level. Although the Bank has a diversified loan portfolio, loans outstanding to individuals and businesses depend upon the local economic conditions in the immediate trade area.

One of the primary functions of the Corporation's asset/liability management committee is to monitor the level to which the balance sheet is subject to interest rate risk. The goal of the asset/liability committee is to manage the relationship between interest rate sensitive assets and liabilities, thereby minimizing the fluctuations in the net interest margin, which achieves consistent growth of net interest income during periods of changing interest rates.

Interest rate sensitivity is the result of differences in the amounts and repricing dates of the Bank's rate sensitive assets and rate sensitive liabilities. These differences, or interest rate repricing "gap", provide an indication of the extent that the Corporation's net interest income is affected by future changes in interest rates. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities and is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

Assumptions about the timing and variability of cash flows are critical in gap analysis. Particularly important are the assumptions driving mortgage prepayments and the expected attrition of the core deposits portfolios. These assumptions are based on the Corporation's historical experience, industry standards and assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation's assets and liabilities to interest rate changes. As of September 30, 2016, the Corporation's interest-earning assets maturing or repricing within one year totaled \$198.4 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$182.5 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$15.9 million. At September 30, 2016, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 108.7%.

For more information, see “Market Risk Management” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015.

**Item 4. Controls and Procedures**

The Corporation maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation’s Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to the Corporation’s management, including its Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosure based on the definition of “disclosure controls and procedures” in Rule 13a-15(e).

As of September 30, 2016, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation’s management, including the Corporation’s CEO and CFO, of the effectiveness of the design and operation of the Corporation’s disclosure controls and procedures. Based on the foregoing, the Corporation’s CEO and CFO concluded that the Corporation’s disclosure controls and procedures were effective. There have been no significant changes in the Corporation’s internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

There has been no change made in the Corporation's internal control over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Corporation is involved in various legal proceedings occurring in the ordinary course of business. It is the opinion of management, after consultation with legal counsel, that these matters will not materially affect the Corporation's consolidated financial position or results of operations.

### **Item 1A. Risk Factors**

Not applicable.

### **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**

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

**Exhibit 31.1** Rule 13a-14(a) Certification of Principal Executive Officer

**Exhibit 31.2** Rule 13a-14(a) Certification of Principal Financial Officer

**Exhibit 32.1** CEO Certification Pursuant to 18 U.S.C. Section 1350

**Exhibit 32.2** CFO Certification Pursuant to 18 U.S.C. Section 1350

**101.INS** XBRL Instance Document

**101.SCH** XBRL Taxonomy Extension Schema Document

**101.CAL** XBRL Taxonomy Extension Calculation Linkbase Document

**101.DEF** XBRL Taxonomy Extension Definitions Linkbase Document

**101.LAB** XBRL Taxonomy Extension Label Linkbase Document

**101.PRE** XBRL Taxonomy Extension Presentation Linkbase Document



**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.

EMCLAIRE  
FINANCIAL CORP

Date: November 14, 2016 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: November 14, 2016 By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer