

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
November 16, 2015

**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, 2015**

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 2,138,358 at November 16, 2015.

**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, 2015 and December 31, 2014

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

	September 30, 2015	December 31, 2014
Assets		
Cash and due from banks	\$ 2,668	\$ 2,386
Interest earning deposits with banks	9,597	9,470
Cash and cash equivalents	12,265	11,856
Securities available for sale	121,324	149,861
Loans receivable, net of allowance for loan losses of \$5,079 and \$5,224	406,044	379,648
Federal bank stocks, at cost	2,182	2,406
Bank-owned life insurance	10,973	10,728
Accrued interest receivable	1,595	1,543
Premises and equipment, net	15,042	15,144
Goodwill	3,664	3,664
Core deposit intangible, net	603	749
Prepaid expenses and other assets	8,716	6,310
<b>Total Assets</b>	<b>\$ 582,408</b>	<b>\$ 581,909</b>
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	\$ 117,466	\$ 111,282
Interest bearing	387,693	390,537
Total deposits	505,159	501,819
Short-term borrowed funds	1,400	6,500

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Long-term borrowed funds	15,000	15,000
Accrued interest payable	186	199
Accrued expenses and other liabilities	7,259	10,401
<b>Total Liabilities</b>	<b>529,004</b>	<b>533,919</b>
<b>Commitments and Contingent Liabilities</b>	<b>-</b>	<b>-</b>
<b>Stockholders' Equity:</b>		
Preferred stock, \$1.00 par value, 3,000,000 shares authorized; Series B, non-cumulative preferred stock, \$0 and \$5,000 liquidation value, no shares and 5,000 shares issued and outstanding	-	5,000
Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,240,375 and 1,882,675 shares issued; 2,138,358 and 1,780,658 shares outstanding, respectively	2,800	2,353
Additional paid-in capital	27,648	19,740
Treasury stock, at cost; 102,017 shares	(2,114)	(2,114)
Retained earnings	27,794	26,009
Accumulated other comprehensive loss	(2,724)	(2,998)
<b>Total Stockholders' Equity</b>	<b>53,404</b>	<b>47,990</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 582,408</b>	<b>\$ 581,909</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, 2015 and 2014

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Interest and dividend income:				
Loans receivable, including fees	\$ 4,382	\$ 4,140	\$ 13,051	\$ 12,259
Securities:				
Taxable	481	521	1,525	1,417
Exempt from federal income tax	205	244	640	763
Federal bank stocks	30	33	132	112
Interest earning deposits with banks	15	30	50	68
Total interest and dividend income	5,113	4,968	15,398	14,619
Interest expense:				
Deposits	532	616	1,613	1,784
Borrowed funds	155	174	514	503
Total interest expense	687	790	2,127	2,287
Net interest income	4,426	4,178	13,271	12,332
Provision for (recovery of) loan losses	(102 )	163	269	508
Net interest income after provision for (recovery of) loan losses	4,528	4,015	13,002	11,824
Noninterest income:				
Fees and service charges	387	411	1,113	1,182
Commissions on financial services	14	8	24	31
Title premiums	13	16	29	40
Net gain on sales of available for sale securities	533	91	567	748
Earnings on bank-owned life insurance	98	97	293	289
Other	334	306	980	911
Total noninterest income	1,379	929	3,006	3,201
Noninterest expense:				
Compensation and employee benefits	2,003	1,825	6,122	5,599
Premises and equipment	646	634	1,970	1,837
Intangible asset amortization	49	54	146	167

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Professional fees	181	142	560	488
Federal deposit insurance	92	90	287	266
Other	956	936	2,817	3,251
Total noninterest expense	3,927	3,681	11,902	11,608
Income before provision for income taxes	1,980	1,263	4,106	3,417
Provision for income taxes	460	241	877	675
Net income	1,520	1,022	3,229	2,742
Preferred stock dividends	25	25	75	75
Net income available to common stockholders	\$ 1,495	\$ 997	\$ 3,154	\$ 2,667
Basic earnings per common share	\$ 0.70	\$ 0.56	\$ 1.64	\$ 1.51
Diluted earnings per common share	0.70	0.56	1.63	1.49
Average common shares outstanding - basic	2,136,749	1,770,821	1,928,789	1,770,128
Average common shares outstanding - diluted	2,148,713	1,787,231	1,939,708	1,784,837

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, 2015 and 2014

(Dollar amounts in thousands)

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Net income	\$ 1,520	\$ 1,022	\$ 3,229	\$ 2,742
Other comprehensive income				
Unrealized gains on securities:				
Unrealized holding gain (loss) arising during the period	1,200	(194 )	982	2,560
Reclassification adjustment for gains included in net income	(533 )	(91 )	(567 )	(748 )
	667	(285 )	415	1,812
Tax effect	(227 )	97	(141 )	(616 )
Net of tax	440	(188 )	274	1,196
Comprehensive income	\$ 1,960	\$ 834	\$ 3,503	\$ 3,938

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

## Condensed Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended September 30, 2015 and 2014

(Dollar amounts in thousands)

	For the nine months ended September 30, 2015	2014
Cash flows from operating activities		
Net income	\$ 3,229	\$ 2,742
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	751	631
Provision for loan losses	269	508
Amortization of premiums, net	246	198
Amortization of intangible assets and mortgage servicing rights	146	168
Realized gains on sales of available for sale securities, net	(567 )	(748 )
Net gains on foreclosed real estate	(25 )	(11 )
Write-down of foreclosed real estate	6	-
Stock compensation expense	150	126
Increase in bank-owned life insurance, net	(245 )	(243 )
Increase in accrued interest receivable	(52 )	(208 )
	(2,504 )	232

(Increase) decrease in prepaid expenses and other assets				
Decrease in accrued interest payable	(13	)	(75	)
Increase (decrease) in accrued expenses and other liabilities	(124	)	3,999	
Net cash provided by operating activities	1,267		7,319	
Cash flows from investing activities				
Loan originations and principal collections, net	(3,764	)	(16,619	)
Purchase of residential mortgage loans	(19,481	)	-	
Settlement of syndicated national credits	(7,039	)	-	
Available for sale securities:				
Sales	30,691		22,462	
Maturities, repayments and calls	19,382		10,270	
Purchases	(20,540	)	(63,189	)
Redemption of federal bank stocks	224		1,186	
Proceeds from the sale of foreclosed real estate	317		139	
Additions to premises and equipment	(649	)	(2,615	)
Net cash used in investing activities	(859	)	(48,366	)
Cash flows from financing activities				
Net increase in deposits	3,340		87,902	
Repayments on Federal Home Loan Bank advances	-		(5,000	)
Net change in short-term borrowings	(5,100	)	(22,000	)
Proceeds from exercise of stock	54		48	

options, including tax benefit				
Dividends paid	(1,444	)	(1,243	)
Proceeds from the issuance of common stock	8,151		-	
Redemption of preferred stock (Series B)	(5,000	)	-	
Net cash provided by financing activities	1		59,707	
Increase in cash and cash equivalents	409		18,660	
Cash and cash equivalents at beginning of period	11,856		16,658	
Cash and cash equivalents at end of period	\$ 12,265		\$ 35,318	
Supplemental information:				
Interest paid	\$ 2,140		\$ 2,362	
Income taxes paid	525		245	
Supplemental noncash disclosure:				
Transfers from loans to foreclosed real estate	341		124	

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

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

For the three and nine months ended September 30, 2015 and 2014

(Dollar amounts in thousands, except per share data)

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Balance at beginning of period	\$ 56,901	\$ 47,457	\$ 47,990	\$ 45,072
Net income	1,520	1,022	3,229	2,742
Other comprehensive income (loss)	440	(188 )	274	1,196
Stock compensation expense	42	42	150	126
Dividends declared on preferred stock	(25 )	(25 )	(75 )	(75 )
Dividends declared on common stock	(513 )	(390 )	(1,369 )	(1,168 )
Exercise of stock options, including tax benefit	50	23	54	48
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	\$ 53,404	\$ 47,941	\$ 53,404	\$ 47,941
Cash dividend per common share	\$ 0.24	\$ 0.22	\$ 0.72	\$ 0.66

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, 2014, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC.

The balance sheet at December 31, 2014 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. Issuance of Common Stock**

On June 10, 2015, the Corporation sold 350,000 shares of common stock, par value \$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.

**3. 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.

**4. 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, 2015	September 30, 2014	September 30, 2015	September 30, 2014
Earnings per common share - basic				
Net income	\$1,520	\$1,022	\$3,229	\$2,742
Less: Preferred stock dividends	25	25	75	75
Net income available to common stockholders	\$1,495	\$997	\$3,154	\$2,667
Average common shares outstanding	2,136,749	1,770,821	1,928,789	1,770,128
Basic earnings per common share	\$0.70	\$0.56	\$1.64	\$1.51
Earnings per common share - diluted				
Net income available to common stockholders	\$1,495	\$997	\$3,154	\$2,667
Average common shares outstanding	2,136,749	1,770,821	1,928,789	1,770,128



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Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options	11,964	16,410	10,919	14,709
Average shares and dilutive potential common shares	2,148,713	1,787,231	1,939,708	1,784,837
Diluted earnings per common share	\$0.70	\$0.56	\$1.63	\$1.49
Stock options not considered in computing earnings per share because they were antidilutive	67,000	66,000	67,000	67,000

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**5. Securities**

The following table summarizes the Corporation's securities as of September 30, 2015 and December 31, 2014:

(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale:				
September 30, 2015:				
U.S. Treasury and federal agency	\$ 1,493	\$ -	\$ (6)	) \$ 1,487
U.S. government sponsored entities and agencies	17,205	41	(1)	) 17,245
U.S. agency mortgage-backed securities: residential	34,102	678	-	) 34,780
U.S. agency collateralized mortgage obligations: residential	33,489	56	(549)	) 32,996
State and political subdivisions	27,956	177	(72)	) 28,061
Corporate debt securities	4,008	5	(6)	) 4,007
Equity securities	2,356	399	(7)	) 2,748
	\$ 120,609	\$ 1,356	\$ (641)	) \$ 121,324
December 31, 2014:				
U.S. Treasury and federal agency	\$ 1,491	\$ -	\$ (35)	) \$ 1,456
U.S. government sponsored entities and agencies	35,452	10	(238)	) 35,224
U.S. agency mortgage-backed securities: residential	38,026	745	-	) 38,771
U.S. agency collateralized mortgage obligations: residential	37,564	16	(963)	) 36,617
State and political subdivisions	32,665	550	(191)	) 33,024
Corporate debt securities	2,006	-	(8)	) 1,998
Equity securities	2,356	415	-	) 2,771
	\$ 149,560	\$ 1,736	\$ (1,435)	) \$ 149,861

The following table summarizes scheduled maturities of the Corporation's debt securities as of September 30, 2015. 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	
	Amortized Cost	Fair Value
Due in one year or less	\$-	\$-
Due after one year through five years	30,877	30,988
Due after five through ten years	18,556	18,586

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Due after ten years	1,229	1,226
Mortgage-backed securities: residential	34,102	34,780
Collateralized mortgage obligations: residential	33,489	32,996
	\$118,253	\$118,576

**5. Securities (continued)**

Information pertaining to securities with gross unrealized losses at September 30, 2015 and December 31, 2014, 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
Description of Securities						
September 30, 2015:						
U.S. Treasury and federal agency	\$ -	\$ -	\$ 1,487	\$ (6 )	\$ 1,487	\$ (6 )
U.S. government sponsored entities and agencies	-	-	1,999	(1 )	1,999	(1 )
U.S. agency collateralized mortgage obligations: residential	-	-	26,611	(549 )	26,611	(549 )
State and political subdivisions	4,439	(14 )	2,974	(58 )	7,413	(72 )
Corporate debt securities	2,001	(5 )	500	(1 )	2,501	(6 )
Equity securities	243	(7 )	-	-	243	(7 )
	\$ 6,683	\$ (26 )	\$ 33,571	\$ (615 )	\$ 40,254	\$ (641 )
December 31, 2014:						
U.S. Treasury and federal agency	\$ -	\$ -	\$ 1,456	\$ (35 )	\$ 1,456	\$ (35 )
U.S. government sponsored entities and agencies	11,412	(51 )	16,805	(187 )	28,217	(238 )
U.S. agency collateralized mortgage obligations: residential	2,715	(14 )	30,594	(949 )	33,309	(963 )
State and political subdivisions	5,154	(22 )	10,221	(169 )	15,375	(191 )
Corporate debt securities	1,998	(8 )	-	-	1,998	(8 )
	\$ 21,279	\$ (95 )	\$ 59,076	\$ (1,340 )	\$ 80,355	\$ (1,435 )

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,	
	2015	2014	2015	2014
Proceeds	\$ 28,900	\$ 903	\$ 30,691	\$ 22,462
Gains	533	91	567	748
Tax provision related to gains	181	31	193	254

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.

## 5. Securities (continued)

There was one equity security in an unrealized loss position for less than 12 months as of September 30, 2015. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment security is in an unrealized loss position 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, 2015 to be other-than-temporarily impaired.

There were 54 debt securities in an unrealized loss position as of September 30, 2015, of which 40 were in an unrealized loss position for more than 12 months. Of these 40 securities, 2 were U.S. Treasury securities, 1 was a U.S. government sponsored entity and agency security, 22 were government-backed collateralized mortgage obligations, 14 were state and political subdivision securities and 1 was a corporate debt security. 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, 2015 to be other-than-temporarily impaired.

**6. 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, 2015	December 31, 2014
Mortgage loans on real estate:		
Residential first mortgages	\$ 133,628	\$ 107,173
Home equity loans and lines of credit	89,398	89,106
Commercial real estate	112,686	110,810
	335,712	307,089
Other loans:		
Commercial business	68,499	70,185
Consumer	6,912	7,598
	75,411	77,783
Total loans, gross	411,123	384,872
Less allowance for loan losses	5,079	5,224
Total loans, net	\$ 406,044	\$ 379,648

During the second quarter of 2015, the Corporation purchased four syndicated national credits (SNCs) each having a principal amount of \$1.0 million. The SNCs were purchased for a total of \$4.0 million plus a net premium of \$21,000 which is being amortized over the lives of the loans. During the third quarter of 2014, the Corporation purchased four SNCs each having a principal amount of \$1.0 million. The SNCs were purchased for a total of \$4.0 million plus a net premium of \$15,000 and other costs totaling \$11,000 which are being amortized over the lives of the loans. The SNCs are recorded as commercial business loans and are collateralized by all business assets of the individual borrowers. Until sufficient historical performance data can be collected and analyzed, these credits are assigned allowance for loan losses equal to a multiple of the Corporation's normal allowance allocation for Bank originated commercial business loans. During the nine months ended September 30, 2015, the Corporation received \$2.2 million in principal payments on these SNC's, including two full payoffs totaling \$2.0 million. As of September 30, 2015, these SNC's had a remaining outstanding balance of \$5.8 million.

**6. 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 Interest Recognized
	As of September 30, 2015			ended September 30, 2015		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Interest Recognized 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 Interest Recognized
	ended September 30, 2015			
	Average Recorded Investment	Interest Income Recognized in Period		Interest Recognized 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**

For the three months

As of September 30,  
2015

ended September 30, 2015

	Unpaid Principal	Recorded	Average Recorded	Interest Income Recognized	Cash Basis Interest Recognized



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	Balance	Investment	Investment	in Period	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 Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized 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

**6. 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, 2014:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the year ended		Cash Basis Interest Recognized in Period
	As of December 31, 2014			December 31, 2014		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	
Residential first mortgages	\$ 171	\$ 171	\$ 27	\$ 136	\$ 12	\$ 12
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,615	2,674	268	2,673	16	-
Commercial business	2,622	2,622	495	1,524	66	-
Consumer	-	-	-	-	-	-
<b>Total</b>	<b>\$ 6,408</b>	<b>\$ 5,467</b>	<b>\$ 790</b>	<b>\$ 4,333</b>	<b>\$ 94</b>	<b>\$ 12</b>
	Impaired Loans with No Specific Allowance			For the year ended		
	As of December 31, 2014			December 31, 2014		
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages	\$ 114	\$ 114	\$ 74	\$ 2	\$ -	
Home equity and lines of credit	-	-	-	-	-	
Commercial real estate	1,254	855	839	15	4	
Commercial business	51	51	250	1	1	
Consumer	-	-	1,078	533	533	
<b>Total</b>	<b>\$ 1,419</b>	<b>\$ 1,020</b>	<b>\$ 2,241</b>	<b>\$ 551</b>	<b>\$ 538</b>	

**6. 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, 2014:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the three months		Cash Basis Interest Recognized in Period
	As of September 30, 2014			ended September 30, 2014		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	
Residential first mortgages	\$ 171	\$ 171	\$ 28	\$ 172	\$ 1	\$ 1
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,681	2,740	223	2,724	3	-
Commercial business	2,372	2,372	445	2,291	-	-
Consumer	-	-	-	-	-	-
<b>Total</b>	<b>\$ 6,224</b>	<b>\$ 5,283</b>	<b>\$ 696</b>	<b>\$ 5,187</b>	<b>\$ 4</b>	<b>\$ 1</b>

	For the nine months			Cash Basis Interest Recognized in Period
	ended September 30, 2014			
	Average Recorded Investment	Interest Income Recognized in Period		
Residential first mortgages	\$ 126	\$ 10	\$ 10	
Home equity and lines of credit	-	-	-	
Commercial real estate	2,673	16	-	
Commercial business	1,250	53	-	
Consumer	-	-	-	
<b>Total</b>	<b>\$ 4,049</b>	<b>\$ 79</b>	<b>\$ 10</b>	

**Impaired Loans with No Specific Allowance**

	For the three months			Cash Basis Interest Recognized
	As of September 30, 2014			
	Unpaid Principal	Recorded	Average Recorded	Interest Income Recognized

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	Balance	Investment	Investment	in Period	in Period
Residential first mortgages	\$ 116	\$ 116	\$ 117	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-
Commercial real estate	1,269	870	980	-	-
Commercial business	52	52	240	-	-
Consumer	1,348	1,348	1,348	-	-
Total	\$ 2,785	\$ 2,386	\$ 2,685	\$ -	\$ -

For the nine months  
ended September 30, 2014

	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ 64	\$ 2	\$ -
Home equity and lines of credit	-	-	-
Commercial real estate	835	14	3
Commercial business	300	1	1
Consumer	1,348	-	-
Total	\$ 2,547	\$ 17	\$ 4

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 based on the amounts not being material.

## 6. 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, 2015 and December 31, 2014, the Corporation had \$2.6 million and \$5.6 million, respectively, of loans classified as TDRs, which are included in impaired loans above. At September 30, 2015 and December 31, 2014, the Corporation had \$64,000 and \$513,000 of the allowance for loan losses allocated to these specific loans.

During the three and nine month periods ended September 30, 2015, the Corporation did not modify any loans as TDRs. During the three month period ended September 30, 2014, the Corporation did not modify any loans as TDRs. During the nine month period ended September 30, 2014, the Corporation modified eleven loans to be identified as TDRs. One commercial relationship consisting of eight loans totaling \$2.4 million was modified as the Bank granted repayment concessions due to financial difficulties experienced by the borrower. Concessions on these eight loans included reduced monthly payments through the notes' maturities. An additional commercial real estate relationship consisting of two loans totaling \$2.1 million was modified as the Bank granted a payment concession on one loan and interest rate concessions on both loans due to cash flow considerations caused by vacancy rates. In addition, the Corporation modified a residential mortgage loan with pre- and post-modification recorded investments of \$76,000 and \$93,000, respectively, due to a bankruptcy court order. The modifications included capitalization of \$5,000 of accrued and unpaid interest and \$13,000 of legal expenses, a reduction in the interest rate from 6.25% to 5.00% and a 15 year extension of the original term. Because these loans were previously impaired with specific reserves allocated to them, there was no impact to the provision for loan losses for the nine month period ended September 30, 2014 as a result of the modifications.

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, 2015, there was a default on one \$90,000 residential mortgage loan within 12 months following modification classified as a TDR at September 30, 2015. At September 30, 2015, this loan was over 90 days past due. This default had no impact on the provision for loan losses for the quarter ending September 30, 2015. During the three and nine month periods ended September 30, 2014, there were defaults on four loans classified as TDRs which totaled \$1.8 million at September 30, 2014. Of these, two loans totaling \$344,000 were not past due, one loan for \$81,000 was 30-59 days delinquent and one loan for \$1.3 million was over 90 days past due at September 30, 2014.

***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.

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

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.

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, 2015 and December 31, 2014:

(Dollar amounts in thousands)

	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2015:						
Residential first mortgages	\$ 132,249	\$-	\$ -	\$ 1,379	\$ -	\$ 133,628
Home equity and lines of credit	89,009	-	-	389	-	89,398
Commercial real estate	-	106,687	93	5,906	-	112,686
Commercial business	-	66,304	887	1,308	-	68,499
Consumer	6,912	-	-	-	-	6,912
<b>Total</b>	<b>\$ 228,170</b>	<b>\$ 172,991</b>	<b>\$ 980</b>	<b>\$ 8,982</b>	<b>\$ -</b>	<b>\$ 411,123</b>
December 31, 2014:						
Residential first mortgages	\$ 106,448	\$-	\$ -	\$ 725	\$ -	\$ 107,173
Home equity and lines of credit	88,699	-	-	407	-	89,106
Commercial real estate	-	103,908	515	6,387	-	110,810
Commercial business	-	65,627	1,292	3,266	-	70,185
Consumer	7,598	-	-	-	-	7,598
<b>Total</b>	<b>\$ 202,745</b>	<b>\$ 169,535</b>	<b>\$ 1,807</b>	<b>\$ 10,785</b>	<b>\$ -</b>	<b>\$ 384,872</b>



**6. 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, 2015 and December 31, 2014:

(Dollar amounts in thousands)

	Performing Accruing	Accruing 30-59 Days Past Due	Accruing 60-89 Days Past Due	Nonperforming Accruing 90 Days + Past Due	Nonaccrual	Total Loans
September 30, 2015:						
Residential first mortgages	\$ 131,297	\$ 951	\$ -	\$ 169	\$ 1,211	\$ 133,628
Home equity and lines of credit	88,668	294	48	-	388	89,398
Commercial real estate	110,056	100	-	-	2,530	112,686
Commercial business	67,765	-	-	-	734	68,499
Consumer	6,860	37	15	-	-	6,912
Total loans	\$ 404,646	\$ 1,382	\$ 63	\$ 169	\$ 4,863	\$ 411,123
December 31, 2014:						
Residential first mortgages	\$ 104,523	\$ 1,523	\$ 402	\$ 78	\$ 647	\$ 107,173
Home equity and lines of credit	87,982	675	42	-	407	89,106
Commercial real estate	107,292	30	55	16	3,417	110,810
Commercial business	67,808	-	-	-	2,377	70,185
Consumer	7,545	41	12	-	-	7,598
Total loans	\$ 375,150	\$ 2,269	\$ 511	\$ 94	\$ 6,848	\$ 384,872

The following table presents the Corporation's nonaccrual loans by aging category as of September 30, 2015 and December 31, 2014:

(Dollar amounts in thousands)

	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total Loans
September 30, 2015:					
Residential first mortgages	\$ 155	\$ -	\$ -	\$ 1,056	\$ 1,211

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Home equity and lines of credit	-	15	-	373	388
Commercial real estate	2,357	55	-	118	2,530
Commercial business	705	-	-	29	734
Consumer	-	-	-	-	-
Total loans	\$ 3,217	\$ 70	\$ -	\$ 1,576	\$4,863
December 31, 2014:					
Residential first mortgages	\$ 283	\$ -	\$ 80	\$ 284	\$647
Home equity and lines of credit	33	18	-	356	407
Commercial real estate	2,848	-	-	569	3,417
Commercial business	2,151	-	188	38	2,377
Consumer	-	-	-	-	-
Total loans	\$ 5,315	\$ 18	\$ 268	\$ 1,247	\$6,848

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.

**6. 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 Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
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
September 30, 2015:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	28	-	5	158	-	191
Collectively evaluated for impairment	1,360	616	1,963	904	45	4,888
Total loans:						
Individually evaluated for impairment	170	-	2,624	1,017	-	3,811
Collectively evaluated for impairment	133,458	89,398	110,062	67,482	6,912	407,312

At December 31, 2014:

Ending ALL balance attributable to loans:

Individually evaluated for impairment	27	-	268	495	-	790
Collectively evaluated for impairment	928	543	2,070	841	52	4,434

Total loans:

Individually evaluated for impairment	285	-	3,529	2,673	-	6,487
Collectively evaluated for impairment	106,888	89,106	107,281	67,512	7,598	378,385

Three months ended September 30, 2014:

Allowance for loan losses:

Beginning Balance	\$ 917	\$ 468	\$ 2,375	\$ 1,233	\$ 53	\$ 5,046
Charge-offs	(38 )	(30 )	-	-	(24 )	(92 )
Recoveries	-	-	4	-	9	13
Provision	62	101	(11 )	(3 )	14	163
Ending Balance	\$ 941	\$ 539	\$ 2,368	\$ 1,230	\$ 52	\$ 5,130

Nine months ended September 30, 2014:

Allowance for loan losses:

Beginning Balance	\$ 923	\$ 625	\$ 2,450	\$ 822	\$ 49	\$ 4,869
Charge-offs	(135 )	(44 )	(2 )	(17 )	(91 )	(289 )
Recoveries	-	-	13	7	22	42
Provision	153	(42 )	(93 )	418	72	508
Ending Balance	\$ 941	\$ 539	\$ 2,368	\$ 1,230	\$ 52	\$ 5,130

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.

## 7. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of September 30, 2015 and December 31, 2014:

(Dollar amounts in thousands)	September 30, 2015		December 31, 2014	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$ 3,664	\$ -	\$ 3,664	\$ -
Core deposit intangibles	4,027	3,424	4,027	3,278
Total	\$ 7,691	\$ 3,424	\$ 7,691	\$ 3,278

Goodwill resulted from three previous branch acquisitions. Goodwill represents the excess of the total purchase price paid for the branch acquisitions over the fair value of the 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 2014 or in the first nine months of 2015. The core deposit intangible asset is amortized using the double declining balance method over a weighted average estimated life of nine years and is not estimated to have a significant residual value. During the three and nine month periods ending September 30, 2015, the Corporation recorded intangible amortization expense totaling \$49,000 and \$146,000, respectively, compared to \$54,000 and \$167,000, respectively, for the same periods in 2014.

## 8. 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, 2015, 83,433 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, 2015, 1,663 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.

A summary of option activity under the Plans as of September 30, 2015, and changes during the period then ended is presented below:

	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted-Average Remaining Term (in years)
Outstanding as of January 1, 2015	76,750	\$ 25.16	\$ 54,720	2.7
Granted	-	-	-	-
Exercised	(3,750 )	14.41	-	-
Forfeited	-	-	-	-
Outstanding as of September 30, 2015	73,000	\$ 25.71	\$ 2,400	1.8
Exercisable as of September 30, 2015	73,000	\$ 25.71	\$ 2,400	1.8

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

A summary of the status of the Corporation's nonvested restricted stock awards as of September 30, 2015, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2015	25,450	\$ 23.03
Granted	-	-
Vested	(3,950 )	19.85
Forfeited	-	-
Nonvested as of September 30, 2015	21,500	\$ 23.62

For the three and nine month periods ended September 30, 2015, the Corporation recognized \$42,000 and \$150,000, respectively, in stock compensation expense, compared to \$42,000 and \$126,000, respectively for the same periods in 2014. As of September 30, 2015, there was \$229,000 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.

**9. 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.

*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.



## 9. Fair Value (continued)

*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, 2015, the fair value of impaired loans measured using the fair value of collateral consisted of loan balances of \$670,000, net of a valuation allowance of \$223,000, compared to loan balances of \$3.0 million, net of a valuation allowance of \$596,000, at December 31, 2014. 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. There was \$41,000 and \$707,000 of additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2014.

*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, 2015, OREO measured at fair value less costs to sell had a net carrying amount of \$20,000, which was made up of the outstanding balance of \$23,000 and write-downs of \$3,000. At December 31, 2014, the Corporation had no OREO measured at fair value. There was \$0 and \$3,000 of expense recorded during the three and nine months ended September 30, 2015 associated with the write-down of OREO, compared to \$0 for the same periods in 2014.

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.

**9. Fair Value (continued)**

*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)	(Level 3)
Description	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
September 30, 2015:				
U.S. Treasury and federal agency	\$ 1,487	\$ 1,487	\$ -	\$ -
U.S. government sponsored entities and agencies	17,245	-	17,245	-
U.S. agency mortgage-backed securities: residential	34,780	-	34,780	-
U.S. agency collateralized mortgage obligations: residential	32,996	-	32,996	-
State and political subdivision	28,061	-	28,061	-
Corporate debt securities	4,007	-	4,007	-
Equity securities	2,748	1,916	-	832
	\$ 121,324	\$ 3,403	\$ 117,089	\$ 832
December 31, 2014:				
U.S. Treasury and federal agency	\$ 1,456	\$ 1,456	\$ -	\$ -
U.S. government sponsored entities and agencies	35,224	-	35,224	-
U.S. agency mortgage-backed securities: residential	38,771	-	38,771	-
U.S. agency collateralized mortgage obligations: residential	36,617	-	36,617	-
State and political subdivisions	33,024	-	33,024	-
Corporate debt securities	1,998	-	1,998	-
Equity securities	2,771	1,873	-	898
	\$ 149,861	\$ 3,329	\$ 145,634	\$ 898

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, 2015 and 2014, 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, 2015 and 2014:

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(Dollar amounts in thousands)	Three months ended		Nine months ended	
	September 30, 2015	September 30, 2014	September 30, 2015	September 30, 2014
Balance at the beginning of the period	\$ 835	\$ 653	\$ 898	\$ 653
Total gains or losses (realized/unrealized):	-	-	-	-
Included in earnings	-	-	-	-
Included in other comprehensive income	(3 )	-	(66 )	-
Issuances	-	-	-	-
Transfers in and/or out of Level 3	-	-	-	-
Balance at the end of the period	\$ 832	\$ 653	\$ 832	\$ 653

**9. Fair Value (continued)**

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)		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
September 30, 2015:				
Impaired commercial business loans	\$447	\$ -	\$ -	\$ 447
Other residential real estate owned	20	-	-	20
	\$467	\$ -	\$ -	\$ 467
December 31, 2014:				
Impaired commercial real estate loans	\$495	\$ -	\$ -	\$ 495
Impaired commercial business loans	1,865	-	-	1,865
	\$2,360	\$ -	\$ -	\$ 2,360

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)	Range	
September 30, 2015:					
Impaired commercial business loans	447	Liquidation value of business assets	Adjustment for differences between comparable business assets	71	%
Other residential real estate owned	20	Sales comparison approach	Adjustment for differences between comparable sales	10	%
December 31, 2014:					
Impaired commercial real estate loans	495	Sales comparison approach/ Contractual provision of USDA loan	Adjustment for differences between comparable sales	10	%
Impaired commercial business loans	1,865	Liquidation value of business assets	Adjustment for differences between comparable business assets	44% - 78%	

The two tables above exclude two impaired residential mortgage loans totaling \$142,000, an \$89,000 impaired commercial real estate loan and a \$252,000 impaired commercial business loan classified as TDRs which were measured using a discounted cash flow methodology at September 30, 2015.

**9. 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, 2015 and December 31, 2014:

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Total	Fair Value Measurements using:		
			Level 1	Level 2	Level 3
September 30, 2015:					
Financial Assets:					
Cash and cash equivalents	\$12,265	\$12,265	\$12,265	\$-	\$-
Securities available for sale	121,324	121,324	3,403	117,089	832
Loans, net	406,044	413,281	-	-	413,281
Federal bank stock	2,182	N/A	N/A	N/A	N/A
Accrued interest receivable	1,595	1,595	41	376	1,178
	543,410	548,465	15,709	117,465	415,291
Financial Liabilities:					
Deposits	505,159	506,233	386,395	119,838	-
Borrowed funds	16,400	17,059	-	17,059	-
Accrued interest payable	186	186	7	179	-
	521,745	523,478	386,402	137,076	-

Description	Carrying Amount	Fair Value Total	Fair Value Measurements using:		
			Level 1	Level 2	Level 3
December 31, 2014:					
Financial Assets:					
Cash and cash equivalents	\$11,856	\$11,856	\$11,856	\$-	\$-
Securities available for sale	149,861	149,861	3,329	145,634	898
Loans, net	379,648	385,264	-	-	385,264
Federal bank stock	2,406	N/A	N/A	N/A	N/A
Accrued interest receivable	1,543	1,543	30	434	1,079
	545,314	548,524	15,215	146,068	387,241
Financial Liabilities:					
Deposits	501,819	504,230	380,685	123,545	-
Borrowed funds	21,500	22,338	-	22,338	-
Accrued interest payable	199	199	32	167	-
	523,518	526,767	380,717	146,050	-

### 10. 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, 2015 and 2014 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income (Loss) at July 1, 2015	\$ 32	\$(3,196)	\$(3,164)
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 from Accumulated Other Comprehensive Income For the three months ended September 30, 2015	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 533	Net gain on sale of available-for-sale securities
	(181)	) Provision for income taxes
Total reclassifications for the period	\$ 352	Net of tax

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Loss at July 1, 2014	\$ (486)	)	\$(1,410) \$(1,896)
Other comprehensive income before reclassification	(128)	)	(128)



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Amounts reclassified from accumulated other comprehensive income	(60	)	-	(60	)
Net current period other comprehensive income	(188	)	-	(188	)
Accumulated Other Comprehensive Loss at September 30, 2014	\$	(674	)	\$(1,410)	\$(2,084)

(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the three months ended September 30, 2014	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Loss Components		
Unrealized gains and losses on available-for-sale securities	\$ 91	Net gain on sale of available-for-sale securities
Total reclassifications for the period	\$ 60	) Provision for income taxes Net of tax

**10. 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, 2015 and 2014 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Loss at January 1, 2015	\$ 198	\$(3,196)	\$(2,998)
Other comprehensive income before reclassification	648	-	648
Amounts reclassified from accumulated other comprehensive income	(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 Reclassified from Accumulated Other Comprehensive Income For the nine months ended September 30, 2015	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 567	Net gain on sale of available-for-sale securities
	(193	) Provision for income taxes
Total reclassifications for the period	\$ 374	Net of tax

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income at January 1, 2014	\$ (1,870	)	\$(1,410) \$(3,280)
Other comprehensive income before reclassification	1,690	-	1,690

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Amounts reclassified from accumulated other comprehensive income	(494	) -	(494 )
Net current period other comprehensive income	1,196	-	1,196
Accumulated Other Comprehensive Loss at September 30, 2014	\$ (674	)	\$(1,410) \$(2,084)

(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the nine months ended September 30, 2014	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 748	Net gain on sale of available-for-sale securities
Total reclassifications for the period	(254 \$ 494	) Provision for income taxes Net of tax

## **11. New Accounting Standards**

In January 2014, the Financial Accounting Standards Board (FASB) issued new accounting guidance regarding the reclassification of residential real estate collateralized consumer mortgage loans upon foreclosures. The guidance requires reclassification of a consumer mortgage loan to other real estate owned upon obtaining legal title to the residential property, which could occur either through foreclosure or through a deed in lieu of foreclosure or similar legal agreement. The existence of a borrower redemption right will not prevent the lender from reclassifying a loan to other real estate once the lender obtains legal title to the property. In addition, entities are required to disclose the amount of foreclosed real estate properties and the recorded investment in residential real estate mortgage loans in the process of foreclosure on both an interim and annual basis. The guidance may be applied prospectively or on a modified prospective basis in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2014. Early adoption was permitted. The adoption of this guidance did not have a material impact on the Corporation's consolidated financial statements.

In May 2014, the FASB and the International Accounting Standards Board (IASB) jointly issued a comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under U.S. GAAP and International Financial Reporting Standards (IFRS). The standard's core principle is that an entity will recognize revenue to depict the transfer of 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 and services. The guidance may be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initial application recognized at the date of initial application for the fiscal years and interim periods within those fiscal years beginning after December 15, 2017. Entities are permitted to adopt one year earlier if they choose. The Corporation is currently evaluating the impact of the adoption of this guidance on its financial statements.

In June 2014, the FASB issued new accounting guidance regarding share-based grants that require a performance target that affects vesting and that could be achieved after the requisite service period to be treated as a performance condition. An entity should apply existing guidance that relates to awards with performance conditions that affect vesting to account for such awards. The guidance may be applied prospectively or retrospectively and is effective for fiscal years and interim periods within those years beginning after December 15, 2015. Early adoption is permitted. This guidance will not have a material impact upon adoption as the Corporation has no share-based grants with performance targets that could be achieved after the requisite service period.

In August 2014, the FASB issued new accounting guidance regarding the classification and measurement of foreclosed mortgage loans that are guaranteed by the government (including loans guaranteed by the FHA and the VA). The guidance addressed diversity in practice by requiring creditors to derecognize the mortgage loan upon foreclosure and to recognize a separate other receivable if the following conditions are met: (a) the government guarantee of the loan is not separate from the loan before foreclosure; (b) upon foreclosure, the creditor has the intent to convey the real estate to the guarantor and to make a claim on the guarantee, and also has the ability to make a recovery under the claim; and (c) claim amounts based on the fair value of the property are fixed upon foreclosure. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal

and interest) expected to be recovered from the guarantor. The guidance may be applied prospectively or on a modified retrospective basis in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2014. The transition method applied should be the same as the transition method applied upon implementation of the new accounting guidance issued in January 2014, described above, regarding the reclassification of residential real estate collateralized consumer mortgage loans upon foreclosure. Early adoption was permitted. The adoption of this guidance did not have a material impact on the Corporation's consolidated financial statements.

**12.**

**Subsequent Event**

On October 29, 2015, the Corporation received a \$1.7 million payment to satisfy a nonperforming commercial real estate loan relationship. The Bank had previously recorded a \$941,000 partial charge off on this relationship in 2013 and previously had specific reserves of \$113,000 allocated to the loan relationship as of June 30, 2015.

**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 Emclair Financial Corp and its wholly owned subsidiaries for the three and nine months ended September 30, 2015, compared to the same periods in 2014 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2014, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 28 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 \$499,000 to \$582.4 million at September 30, 2015 from \$581.9 million at December 31, 2014. While total assets remained stable, loans receivable increased \$26.4 million primarily driven by the purchase of \$19.2 million in residential mortgage loans. This loan growth and a \$5.1 million repayment of short term borrowed funds were funded by a \$28.5 million decrease in securities and a \$3.3 million increase in customer deposits.

Total liabilities decreased \$4.9 million, or 0.9%, to \$529.0 million at September 30, 2015 from \$533.9 million at December 31, 2014, resulting primarily from decreases in short term borrowed funds and other liabilities of \$5.1 million and \$3.1 million, respectively, partially offset by a \$3.3 million increase in customer deposits. The \$5.1 million, or 78.5%, decrease in borrowed funds to \$1.4 million at September 30, 2015 from \$6.5 million at December 31, 2014, resulted from a \$3.5 million decrease in the Bank's FHLB overnight borrowings and a \$1.6 million decrease of short term borrowings on the Corporation's line of credit through another correspondent bank. The \$3.1 million, or 30.2%, decrease in accrued expenses and other liabilities to \$7.3 million at September 30, 2015 from \$10.4 million at December 31, 2014, resulted from the settlement of syndicated national credits totaling \$3.0 million. Deposit growth consisted of a \$6.2 million, or 5.6%, increase in noninterest bearing deposits, partially offset by a \$2.8 million decrease in interest bearing deposits.

Stockholders' equity increased \$5.4 million, or 11.3%, to \$53.4 million at September 30, 2015 from \$48.0 million at December 31, 2014. During the quarter ended June 30, 2015, the Corporation successfully completed an \$8.2 million private placement common stock offering and issued 350,000 shares of common stock. During the quarter ended September 30, 2015, the Corporation used a portion of the proceeds from the offering to redeem all \$5.0 million of remaining preferred stock outstanding that had been issued to the United States Treasury Department pursuant to the Small Business Lending Fund program. Book value and tangible book value per common share were \$24.97 and \$22.98, respectively, at September 30, 2015, compared to \$24.14 and \$21.66, respectively, at December 31, 2014.

At September 30, 2015, the Bank was considered "well-capitalized" under the new Basel III capital rules with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.84%, 13.76%, 13.76% and 15.02%, respectively. The Bank was also considered "well-capitalized" at December 31, 2014 under the previous U.S. risk-based capital rules with a Tier 1 leverage ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.25%, 14.84% and 13.58%, respectively.

## RESULTS OF OPERATIONS

### Comparison of Results for the Three Months Ended September 30, 2015 and 2014

**General.** Net income increased \$498,000, or 48.7%, to \$1.5 million for the three months ended September 30, 2015 from \$1.0 million for the same period in 2014. This increase was the result of increases in net interest income and noninterest income of \$248,000 and \$450,000, respectively, and a \$265,000 decrease in provision for loan losses, partially offset by increases in noninterest expense and provision for income taxes of \$246,000 and \$219,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis increased \$223,000, or 5.1%, to \$4.6 million for the three months ended September 30, 2015 from \$4.4 million for the three months ended September 30, 2014. This increase can be attributed to an increase in tax equivalent interest income of \$120,000 and a decrease in interest expense of \$103,000.

**Interest income.** Interest income on a tax equivalent basis increased \$120,000, or 2.3%, to \$5.3 million for the three months ended September 30, 2015 from \$5.2 million for the same period in 2014. This increase can be attributed to a \$236,000 increase in interest earned on loans, partially offset by decreases in interest earned on securities, interest earning deposits with banks and dividends on federal bank stocks of \$98,000, \$15,000 and \$3,000, respectively.



Tax equivalent interest earned on loans receivable increased \$236,000, or 5.6%, to \$4.5 million for the three months ended September 30, 2015 compared to \$4.2 million for the same period in 2014. This increase resulted from a \$36.4 million, or 9.9% increase in average loans, accounting for an increase of \$409,000 in interest income. Partially offsetting this favorable volume variance, the average yield on loans decreased 18 basis points to 4.40% for the three months ended September 30, 2015, versus 4.58% for the same period in 2014. This unfavorable yield variance accounted for a \$173,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$98,000, or 11.3%, to \$767,000 for the three months ended September 30, 2015 compared to \$865,000 for the three months ended September 30, 2014. This decrease resulted from a \$10.7 million, or 7.2% decrease in the average balance of securities, accounting for a \$60,000 decrease in interest income. The average yield on securities decreased 10 basis points to 2.21% for the three months ended September 30, 2015, versus 2.31% for the same period in 2014. This unfavorable yield variance accounted for a \$38,000 decrease in interest income.

Interest earned on deposits with banks decreased \$15,000, or 50.0%, to \$15,000 for the three months ended September 30, 2015 compared to \$30,000 for the three months ended September 30, 2014. This decrease resulted from a \$35.6 million decrease in the average balance of interest-earning deposits, accounting for a decrease of \$32,000 in interest income. The average yield on these accounts increased 24 basis points to 0.49% for the three months ended September 30, 2015, versus 0.25% for the same period in 2014, accounting for a \$17,000 increase in interest income.

Dividends on federal bank stocks decreased \$3,000, or 9.1%, to \$30,000 for the three months ended September 30, 2015 from \$33,000 for the same period in 2014. This decrease resulted from a decrease in the average balance of federal bank stocks of \$310,000, or 11.1%, accounting for a \$4,000 decrease in interest income. Partially offsetting this unfavorable volume variance, the average yield on federal bank stocks increased 11 basis points to 4.80% for the three months ended September 30, 2015, compared to 4.69% for the same period in 2014, accounting for a \$1,000 increase in interest income.

**Interest expense.** Interest expense decreased \$103,000, or 13.0%, to \$687,000 for the three months ended September 30, 2015 from \$790,000 for the same period in 2014. This decrease in interest expense can be attributed to a decreases in interest incurred on deposits and borrowed funds of \$84,000 and \$19,000, respectively.

Interest expense incurred on deposits decreased \$84,000, or 13.6%, to \$532,000 for the three months ended September 30, 2015 compared to \$616,000 for the same period in 2014. The average cost of interest-bearing deposits decreased 5 basis points to 0.54% for the three months ended September 30, 2015, compared to 0.59% for the same period in 2014, resulting in a \$46,000 decrease in interest expense. Additionally, the average balance of interest-bearing deposits decreased \$26.4 million, or 6.4%, to \$387.6 million for the three months ended September 30, 2015, compared to \$414.0 million for the same period in 2014 causing a \$38,000 decrease in interest expense. Average noninterest bearing deposits increased \$5.1 million, or 4.4%, to \$120.6 million from \$115.5 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$19,000, or 10.9%, to \$155,000 for the three months ended September 30, 2015, compared to \$174,000 for the same period in the prior year. The average cost of borrowed funds decreased 103 basis points to 2.99% for the three months ended September 30, 2015, compared to 4.02% for the same period in 2014, resulting in a \$34,000 decrease in interest expense. Partially offsetting this favorable yield variance, the average balance of borrowed funds increased \$3.4 million, or 19.8%, to \$20.5 million for the three months ended September 30, 2015, compared to \$17.2 million for the same period in 2014 causing a \$15,000 increase in interest expense. The increase in the average balance of borrowed funds resulted from increased overnight borrowings utilized by the Bank to support loan growth and general operating fluctuations.

**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,					
	2015			2014		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$378,657	\$4,170	4.37 %	\$340,810	\$3,913	4.56 %
Loans, tax exempt	24,672	303	4.88 %	26,088	324	4.93 %
Total loans receivable	403,329	4,473	4.40 %	366,898	4,237	4.58 %
Securities, taxable	105,071	481	1.82 %	114,147	521	1.81 %
Securities, tax exempt	32,582	286	3.48 %	34,156	344	3.99 %
Total securities	137,653	767	2.21 %	148,303	865	2.31 %
Interest-earning deposits with banks	12,252	15	0.49 %	47,867	30	0.25 %
Federal bank stocks	2,481	30	4.80 %	2,791	33	4.69 %
Total interest-earning cash equivalents	14,733	45	1.21 %	50,658	63	0.49 %
Total interest-earning assets	555,715	5,285	3.77 %	565,859	5,165	3.62 %
Cash and due from banks	2,524			2,403		
Other noninterest-earning assets	35,658			31,505		
Total Assets	\$593,897			\$599,767		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$268,979	\$100	0.15 %	\$292,847	\$120	0.16 %
Time deposits	118,625	432	1.44 %	121,144	496	1.62 %
Total interest-bearing deposits	387,604	532	0.54 %	413,991	616	0.59 %
Borrowed funds, short-term	5,541	5	0.36 %	2,150	23	4.31 %
Borrowed funds, long-term	15,000	150	3.97 %	15,000	151	3.98 %
Total borrowed funds	20,541	155	2.99 %	17,150	174	4.02 %
Total interest-bearing liabilities	408,145	687	0.67 %	431,141	790	0.73 %
Noninterest-bearing demand deposits	120,586	-	-	115,485	-	-

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Funding and cost of funds	528,731	687	0.52 %	546,626	790	0.57 %
Other noninterest-bearing liabilities	7,750			5,415		
Total Liabilities	536,481			552,041		
Stockholders' Equity	57,416			47,726		
Total Liabilities and Stockholders' Equity	\$593,897			\$599,767		
Net interest income		\$4,598			\$4,375	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			3.11 %			2.89 %
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			3.28 %			3.07 %

**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, 2015 versus 2014		
	Increase (Decrease) due to		
	Volume	Rate	Total
<b>Interest income:</b>			
Loans	\$ 409	\$ (173 )	\$ 236
Securities	(60 )	(38 )	(98 )
Interest-earning deposits with banks	(32 )	17	(15 )
Federal bank stocks	(4 )	1	(3 )
<b>Total interest-earning assets</b>	<b>313</b>	<b>(193 )</b>	<b>120</b>
<b>Interest expense:</b>			
Interest-bearing deposits	(38 )	(46 )	(84 )
Borrowed funds, short-term	15	(33 )	(18 )
Borrowed funds, long-term	-	(1 )	(1 )
<b>Total interest-bearing liabilities</b>	<b>(23 )</b>	<b>(80 )</b>	<b>(103 )</b>
<b>Net interest income</b>	<b>\$ 336</b>	<b>\$ (113 )</b>	<b>\$ 223</b>

**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, 2015 and 2014 is as follows:

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(Dollar amounts in thousands)	As of or for the three months ended			
	September 30,			
	2015		2014	
Balance at the beginning of the period	\$ 5,370		\$ 5,046	
Provision for (recovery of) loan losses	(102	)	163	
Charge-offs	(209	)	(92	)
Recoveries	20		13	
Balance at the end of the period	\$ 5,079		\$ 5,130	
Nonperforming loans	\$ 5,032		\$ 7,733	
Nonperforming assets	5,199		7,837	
Nonperforming loans to total loans	1.22	%	2.07	%
Nonperforming assets to total assets	0.89	%	1.32	%
Allowance for loan losses to total loans	1.24	%	1.37	%
Allowance for loan losses to non-performing loans	100.93	%	66.34	%

Nonperforming loans decreased \$2.7 million to \$5.0 million at September 30, 2015 from \$7.7 million at September 30, 2014. The decrease in nonperforming loans was primarily due to the full payoff of a \$2.4 million loan relationship during the second quarter of 2015 which was placed on nonaccrual status during the quarter ended June 30, 2014. The relationship, which was considered impaired, consisted of six commercial business loans, one commercial real estate loan and one residential mortgage. The Corporation also received a full payoff of a \$1.3 million nonperforming consumer loan during the fourth quarter of 2014. Additionally, a previously nonperforming \$474,000 commercial relationship was placed back on accrual status during the quarter ended September 30, 2015, after the Corporation received information from the borrower which reflected a strengthened financial condition. Partially offsetting these decreases, a \$525,000 loan relationship consisting of a residential mortgage and a home equity line of credit was placed on nonaccrual status during the quarter ended March 31, 2015 due to the borrower's inadequate cash flow. The loans are secured by a personal residence. In addition, a \$1.1 million loan relationship consisting of two commercial business loans and one commercial real estate loan was placed on nonaccrual status during the quarter ended June 30, 2015 due to the borrower's weakened financial position. The loans are secured by various assets of the business. Of the \$5.0 million in nonperforming loans, \$3.2 million were not past due at September 30, 2015. During the three months ended September 30, 2015, nonperforming loans decreased \$423,000, primarily due to the aforementioned loan that was placed back on accrual status.

As of September 30, 2015, the Corporation's classified and criticized assets amounted to \$10.0 million, or 1.7% of total assets, with \$9.2 million classified as substandard and \$980,000 identified as special mention. This compares to classified and criticized assets of \$12.6 million, or 2.2% of total assets, with \$10.8 million classified as substandard and \$1.8 million identified as special mention at December 31, 2014.

The provision for loan losses decreased \$265,000 to a \$102,000 recovery for the three months ended September 30, 2015 from a \$163,000 expense for the same period in the prior year. While the Corporation's average loan balances increased \$36.4 million for the three months ended September 30, 2015 compared to the same period in the prior year, the provision for loan losses decreased due to a positive impact in the allowance for loan losses following an improvement in the historical loss ratios and the improvement of two large commercial loan relationships which previously had substantial specific reserves allocated.

**Noninterest income.** Noninterest income increased \$450,000, or 48.4%, to \$1.4 million for the three months ended September 30, 2015, compared to \$929,000 for the same period in the prior year. This increase resulted from a \$442,000 increase in net gains on the sale of securities as the Corporation sold \$28.4 million of securities to accommodate loan production. These sales generated net gains totaling \$533,000 during the third quarter of 2015, compared to \$91,000 of net gains realized for the same period in the prior year. Excluding the gains on securities, noninterest income increased \$8,000 to \$846,000 for the quarter ended September 30, 2015 from \$838,000 for the same period in 2014.

**Noninterest expense.** Noninterest expense increased \$246,000, or 6.9%, to \$3.9 million for the three months ended September 30, 2015, compared to \$3.7 million for the same period in the prior year. This increase in noninterest

expense can be attributed to increases in compensation and employee benefits, premises and equipment, professional fees, FDIC expense and other noninterest expense of \$178,000, \$12,000, \$39,000, \$2,000 and \$20,000, respectively, partially offset by a decrease in intangible amortization of \$5,000.

Compensation and employee benefits expense increased \$178,000, or 9.8%, to \$2.0 million for the three months ended September 30, 2015 compared to \$1.8 million for the same period in the prior year. This increase can be attributed to normal salary and wage increases and higher payroll taxes and incentive compensation expense.

Professional fees increased \$39,000, or 27.5%, to \$181,000 for the three months ended September 30, 2015 compared to \$142,000 for the same period in the prior year. This increase primarily related to increased legal costs.

Other noninterest expense increased \$20,000, or 2.1%, to \$956,000 for the three months ended September 30, 2015 compared to \$936,000 for the same period in the prior year.

The Corporation recognized \$49,000 of core deposit intangible amortization expense during the third quarter of 2015 compared to \$54,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the "Notes to Consolidated Financial Statements" beginning on page 6.



**Provision for income taxes.** The provision for income taxes increased \$219,000, or 90.9%, to \$460,000 for the three months ended September 30, 2015 compared to \$241,000 for the same period in the prior year. This increase was driven primarily by the increase in income before provision for taxes of \$717,000, or 56.8%, to \$2.0 million for the three months ended September 30, 2015 compared to \$1.3 million for the same period in the prior year. The Corporation's effective tax rate increased to 23.2% for the third quarter of 2015 from 19.1% for the same quarter in the prior year. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 23.2% for the quarter ended September 30, 2015 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

#### Comparison of Results for the Nine Months Ended September 30, 2015 and 2014

**General.** Net income increased \$487,000, or 17.7%, to \$3.2 million for the nine months ended September 30, 2015 compared to \$2.7 million for the nine months ended September 30, 2014. This increase was the result of a \$939,000 increase in net interest income and a \$239,000 decrease in provision for loan losses, partially offset by a decrease in noninterest income of \$195,000 and increases in noninterest expense and provision for income taxes of \$294,000 and \$202,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis increased \$908,000, or 7.0%, to \$13.8 million for the nine months ended September 30, 2015 from \$12.9 million for the nine months ended September 30, 2014. This increase can be attributed to an increase in tax equivalent interest income of \$748,000 and a decrease in interest expense of \$160,000.

**Interest income.** Interest income on a tax equivalent basis increased \$748,000, or 4.9%, to \$15.9 million for the nine months ended September 30, 2015 from \$15.2 million for the same period in 2014. This increase can be attributed to increases in interest earned on loans and dividends on federal bank stocks of \$820,000 and \$20,000, respectively, partially offset by decreases in interest earned on securities and interest earning deposits with banks of \$74,000 and \$18,000, respectively.

Tax equivalent interest earned on loans receivable increased \$820,000, or 6.6%, to \$13.3 million for the nine months ended September 30, 2015 compared to \$12.5 million for the same period in 2014. This increase resulted from a \$36.5 million, or 10.2% increase in average loans, accounting for an increase of \$1.2 million in interest income. Partially offsetting this favorable volume variance, the average yield on loans decreased 15 basis points to 4.52% for the nine months ended September 30, 2015, versus 4.67% for the same period in 2014. This unfavorable yield variance accounted for a \$424,000 decrease in interest income. Included in interest earned on loans receivable for the nine months ended September 30, 2015, the Corporation recorded \$145,000 of recovered interest related to the payoff of two nonperforming loan relationships totaling \$2.8 million during the second quarter.

Dividends on federal bank stocks increased \$20,000, or 17.9%, to \$132,000 for the nine months ended September 30, 2015 from \$112,000 for the same period in 2014. This increase resulted from an increase in the average yield on federal bank stocks to 7.54% for the nine months ended September 30, 2015, compared to 4.97% for the same period in 2014, accounting for a \$49,000 increase in interest income. The increase in the yield was the result of an increase in the FHLB's quarterly dividend rate and a 2.50% special dividend paid by the FHLB during the first quarter of 2015. Partially offsetting this favorable yield variance, the average balance of federal bank stocks decreased \$673,000, or 22.3%, accounting for a \$29,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$74,000, or 3.0%, to \$2.4 million for the nine months ended September 30, 2015 compared to \$2.5 million for the nine months ended September 30, 2014. This decrease resulted from a 21 basis point decrease in the average yield on securities to 2.22% for the nine months ended September 30, 2015, versus 2.43% for the same period in 2014. This unfavorable yield variance accounted for a \$220,000 decrease in interest income. Partially offsetting this unfavorable yield variance, the average balance of securities increased \$8.3 million, or 6.0%, accounting for an increase of \$146,000 in interest income.

Interest earned on deposits with banks decreased \$18,000, or 26.5%, to \$50,000 for the nine months ended September 30, 2015 compared to \$68,000 for the nine months ended September 30, 2014. The average balance of these accounts decreased \$19.5 million, or 60.1%, accounting for a decrease of \$55,000 in interest income. Partially offsetting the unfavorable volume variance, the average yield on these accounts increased 24 basis points to 0.52% for the nine months ended September 30, 2015, versus 0.28% for the same period in 2014, accounting for a \$37,000 increase in interest income.

**Interest expense.** Interest expense decreased \$160,000, or 7.0%, to \$2.1 million for the nine months ended September 30, 2015 from \$2.3 million for the same period in 2014. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits of \$171,000, partially offset by an increase in interest incurred on borrowed funds of \$11,000.

Interest expense incurred on deposits decreased \$171,000, or 9.6%, to \$1.6 million for the nine months ended September 30, 2015 compared to \$1.8 million for the same period in 2014. The average cost of interest-bearing deposits decreased 8 basis points to 0.55% for the nine months ended September 30, 2015, compared to 0.63% for the same period in 2014, resulting in a \$230,000 decrease in interest expense. Partially offsetting this favorable variance, the average balance of interest-bearing deposits increased \$12.9 million, or 3.4%, to \$393.9 million for the nine months ended September 30, 2015, compared to \$381.0 million for the same period in 2014 causing a \$59,000 increase in interest expense. Average noninterest bearing deposits increased \$5.8 million, or 5.2%, to \$117.6 million from \$111.9 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds increased \$11,000, or 2.2%, to \$514,000 for the nine months ended September 30, 2015, compared to \$503,000 for the same period in the prior year. The average cost of borrowed funds increased 6 basis points to 3.48% for the nine months ended September 30, 2015, compared to 3.42% for the same period in 2014, resulting in a \$22,000 increase in interest expense. Additionally, the average balance of short term borrowed funds increased \$1.2 million, or 33.8%, to \$4.8 million for the nine months ended September 30, 2015, compared to \$3.6 million for the same period in 2014 causing a \$20,000 increase in interest expense. Partially offsetting these unfavorable variances, the average balance of long term borrowed funds decreased \$1.1 million, or 6.9%, to \$15.0 million for the nine months ended September 30, 2015, compared to \$16.1 million for the same period in 2014 causing a \$31,000 decrease in interest expense. Interest expense on long term borrowed funds for the nine months ended September 30, 2014 was reduced by \$53,000 related to capitalized interest costs on the construction of a new branch banking office in Cranberry Township, Pennsylvania, which opened in May 2014.

**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,					
	2015			2014		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$369,508	\$12,407	4.49 %	\$336,455	\$11,685	4.64 %
Loans, tax exempt	25,061	919	4.90 %	21,572	821	5.09 %
Total loans receivable	394,569	13,326	4.52 %	358,027	12,506	4.67 %
Securities, taxable	112,991	1,525	1.80 %	102,382	1,417	1.85 %
Securities, tax exempt	32,797	895	3.65 %	35,090	1,077	4.10 %
Total securities	145,788	2,420	2.22 %	137,472	2,494	2.43 %
Interest-earning deposits with banks	12,971	50	0.52 %	32,511	68	0.28 %
Federal bank stocks	2,340	132	7.54 %	3,013	112	4.97 %
Total interest-earning cash equivalents	15,311	182	1.59 %	35,524	180	0.68 %
Total interest-earning assets	555,668	15,928	3.83 %	531,023	15,180	3.82 %
Cash and due from banks	2,444			2,243		
Other noninterest-earning assets	33,895			31,127		
Total Assets	\$592,007			\$564,393		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$274,186	\$309	0.15 %	\$261,903	\$306	0.16 %
Time deposits	119,691	1,304	1.46 %	119,057	1,478	1.66 %
Total interest-bearing deposits	393,877	1,613	0.55 %	380,960	1,784	0.63 %
Borrowed funds, short-term	4,783	65	1.81 %	3,574	72	2.69 %
Borrowed funds, long-term (1)	15,000	449	4.01 %	16,117	431	3.58 %
Total borrowed funds	19,783	514	3.48 %	19,691	503	3.42 %
Total interest-bearing liabilities	413,660	2,127	0.69 %	400,651	2,287	0.76 %
Noninterest-bearing demand deposits	117,628	-	-	111,854	-	-

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Funding and cost of funds	531,288	2,127	0.54 %	512,505	2,287	0.60 %
Other noninterest-bearing liabilities	8,324			4,954		
Total Liabilities	539,612			517,459		
Stockholders' Equity	52,395			46,934		
Total Liabilities and Stockholders' Equity	\$592,007			\$564,393		
Net interest income		\$13,801			\$12,893	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			3.15 %			3.06 %
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			3.32 %			3.25 %

(1) Interest on long-term borrowed funds for the nine month period ended September 30, 2014 was reduced by \$53,000 related to capitalized interest costs on construction in progress.

**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, 2015 versus 2014		
	Increase (Decrease) due to		
	Volume	Rate	Total
Interest income:			
Loans	\$ 1,244	\$ (424 )	\$ 820
Securities	146	(220 )	(74 )
Interest-earning deposits with banks	(55 )	37	(18 )
Federal bank stocks	(29 )	49	20
Total interest-earning assets	1,306	(558 )	748
Interest expense:			
Interest-bearing deposits	59	(230 )	(171 )
Borrowed funds, short-term	20	(27 )	(7 )
Borrowed funds, long-term	(31 )	49	18
Total interest-bearing liabilities	48	(208 )	(160 )
Net interest income	\$ 1,258	\$ (350 )	\$ 908

**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, 2015 and 2014 is as follows:

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(Dollar amounts in thousands)	As of or for the nine months ended			
	September 30,			
	2015		2014	
Balance at the beginning of the period	\$ 5,224		\$ 4,869	
Provision for loan losses	269		508	
Charge-offs	(509)	)	(289)	)
Recoveries	95		42	
Balance at the end of the period	\$ 5,079		\$ 5,130	
Non-performing loans	\$ 5,032		\$ 7,733	
Non-performing assets	5,199		7,837	
Non-performing loans to total loans	1.22	%	2.07	%
Non-performing assets to total assets	0.89	%	1.32	%
Allowance for loan losses to total loans	1.24	%	1.37	%
Allowance for loan losses to non-performing loans	100.93	%	66.34	%

Nonperforming loans decreased \$2.7 million to \$5.0 million at September 30, 2015 from \$7.7 million at September 30, 2014. The decrease in nonperforming loans was primarily due to the full payoff of a \$2.4 million loan relationship during the second quarter of 2015 which was placed on nonaccrual status during the quarter ended June 30, 2014. The relationship, which was considered impaired, consisted of six commercial business loans, one commercial real estate loan and one residential mortgage. The Corporation also received a full payoff of a \$1.3 million nonperforming consumer loan during the fourth quarter of 2014. Additionally, a previously nonperforming \$474,000 commercial relationship was placed back on accrual status during the quarter ended September 30, 2015, after the Corporation received information from the borrower which reflected a strengthened financial condition. Partially offsetting these decreases, a \$525,000 loan relationship consisting of a residential mortgage and a home equity line of credit was placed on nonaccrual status during the quarter ended March 31, 2015 due to the borrower's inadequate cash flow. The loans are secured by a personal residence. In addition, a \$1.1 million loan relationship consisting of two commercial business loans and one commercial real estate loan was placed on nonaccrual status during the quarter ended June 30, 2015 due to the borrower's weakened financial position. The loans are secured by various assets of the business. Of the \$5.0 million in nonperforming loans, \$3.2 million were not past due at September 30, 2015. During the nine months ended September 30, 2015, nonperforming loans decreased \$1.9 million, due to the aforementioned activity.

As of September 30, 2015, the Corporation's classified and criticized assets amounted to \$10.0 million, or 1.7% of total assets, with \$9.2 million classified as substandard and \$980,000 identified as special mention. This compares to classified and criticized assets of \$12.6 million, or 2.2% of total assets, with \$10.8 million classified as substandard and \$1.8 million identified as special mention at December 31, 2014.

The provision for loan losses decreased \$239,000, or 47.1%, to \$269,000 for the nine months ended September 30, 2015 from \$508,000 for the same period in the prior year. While the Corporation's average loan balances increased \$36.5 million for the nine months ended September 30, 2015 compared to the same period in the prior year, the provision for loan losses decreased due to a positive impact in the allowance for loan losses due to an improvement in the historical loss ratios and the improvement of two large commercial real estate loan relationships which previously had substantial specific reserves allocated.

**Noninterest income.** Noninterest income decreased \$195,000, or 6.1%, to \$3.0 million for the nine months ended September 30, 2015, compared to \$3.2 million for the same period in the prior year. This decrease resulted primarily from a \$181,000 decrease in gains realized on the sale of securities, which were \$748,000 for the nine months ended September 30, 2014 compared to \$567,000 for the same period in 2015. Gains realized in the 2014 period related to a balance sheet management strategy whereby securities were sold to prepay a \$5.0 million FHLB long term advance and associated security gains were used to offset the impact of prepayment penalties associated with the early retirement of the advance. Gain recognized in the 2015 period related to the sale of securities to fund loan growth. Excluding the gains on securities, noninterest income decreased \$14,000 to \$2.4 million for the nine months ended September 30, 2015 and 2014 due to a decrease in fees and service charges of \$69,000, partially offset by an increase in rental income of \$43,000.



**Noninterest expense.** Noninterest expense increased \$294,000 to \$11.9 million for the nine months ended September 30, 2015, compared to \$11.6 million for the same period in the prior year. This increase in noninterest expense can be attributed to increases in compensation and employee benefits, premises and equipment, professional fees and FDIC expense of \$523,000, \$133,000, \$72,000 and \$21,000, respectively, partially offset by decreases in other noninterest expense and intangible amortization of \$434,000 and \$21,000, respectively.

Compensation and employee benefits expense increased \$523,000, or 9.3%, to \$6.1 million for the nine months ended September 30, 2015 compared to \$5.6 million for the same period in the prior year. This increase can be attributed to normal salary and wage increases and higher payroll taxes, employee benefit costs, employee retirement expenses, stock compensation expense and incentive compensation expense.

Premises and equipment expense increased \$133,000, or 7.2%, to \$2.0 million for the nine months ended September 30, 2015 compared to \$1.8 million for the same period in the prior year. This increase is primarily related to an increase in depreciation costs associated with the Cranberry Township branch office which opened in May 2014, and the replacement of the Corporation's fleet of automated teller machines during the fourth quarter of 2014.

Professional fees increased \$72,000, or 14.8%, to \$560,000 for the nine months ended September 30, 2015 compared to \$488,000 for the same period in the prior year. This increase primarily related to increased legal costs and other professional fees related to merger and acquisition related activities.

The Corporation recognized \$146,000 of core deposit intangible amortization expense during the nine months ended September 30, 2015 compared to \$167,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.

FDIC insurance increased \$21,000, or 7.9%, to \$287,000 for the nine months ended September 30, 2015 compared to \$266,000 for the same period in the prior year.

Other noninterest expense decreased \$434,000, or 13.4%, to \$2.8 million for the nine months ended September 30, 2015 compared to \$3.3 million for the same period in the prior year. During the nine months ended September 30, 2014, the Corporation recorded a \$550,000 prepayment penalty assessed on the aforementioned early retirement of debt.

Noninterest expense for the nine months ended September 30, 2015 included \$332,000 in costs related to the Cranberry Township branch office which opened in May 2014, compared to \$220,000 in costs recognized during the same period in 2014. Excluding the costs related to the new branch office and the aforementioned prepayment penalty, noninterest expense increased \$732,000, or 6.8% for the nine months ended September 30, 2015 compared to the same period in the prior year.

**Provision for income taxes.** The provision for income taxes increased \$202,000, or 29.9%, to \$877,000 for the nine months ended September 30, 2015 compared to \$675,000 for the same period in the prior year. This increase was driven primarily by the increase in income before provision for taxes of \$689,000, or 20.2%, to \$4.1 million for the nine months ended September 30, 2015 compared to \$3.4 million for the same period in the prior year. The Corporation’s effective tax rate increased to 21.4% for the first nine months of 2015 from 19.8% for the same quarter in the prior year. The difference between the statutory rate of 34% and the Corporation’s effective tax rate of 19.8% for the nine months ended September 30, 2015 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## LIQUIDITY

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB and Federal Reserve, and amortization and prepayments of outstanding loans and maturing securities. During the nine months ended September 30, 2015, the Corporation used its sources of funds primarily to fund loan purchases and advances. As of September 30, 2015, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$70.1 million, and standby letters of credit totaling \$150,000.

At September 30, 2015, time deposits amounted to \$118.6 million, or 23.5% of the Corporation's total consolidated deposits, including approximately \$37.2 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, 2015, the Corporation had borrowed funds of \$16.4 million consisting of \$15.0 million in long-term FHLB advances and a \$1.4 million short-term advance on a line of credit with a correspondent bank. At September 30, 2015, the Corporation's borrowing capacity with the FHLB, net of funds borrowed and other commitments, was \$161.9 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**

In July 2013, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that revised their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule established a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets), phases out certain kinds of intangibles and instruments treated as capital and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain “available-for-sale” securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-out is exercised. The Bank elected to opt-out of this regulatory capital provision. By opting out of the provision, the Bank retains what is known as the accumulated other comprehensive income filter. The rule limits a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The new capital rules maintain the general structure of the prompt corrective action rules, but incorporate the new common equity Tier 1 capital requirement and the increased Tier 1 risk-weighted asset requirement into the prompt corrective action framework.

The final rule became effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. The final rule also implements consolidated capital requirements for bank holding companies, such as the Corporation, effective January 1, 2015. However, in April 2015, the Federal Reserve raised from \$500 million to \$1 billion the asset size threshold that qualifies a bank holding company for coverage under the Federal Reserve’s Small Bank Holding Company Policy Statement, provided that it meets certain conditions. Among other things, a qualifying bank holding company is not subject to consolidated regulatory capital requirements. The Corporation qualifies for coverage under the Federal Reserve’s Small Bank Holding Company Policy Statement and, therefore, is not subject to consolidated regulatory capital requirements.

## **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, 2014. 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, 2014, 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, 2015, the Corporation's interest-earning assets maturing or repricing within one year totaled \$165.8 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$162.7 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$3.1 million. At September 30, 2015, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 101.9%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2014.

#### **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, 2015, 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 16, 2015 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: November 16, 2015 By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer