

# EMCLAIRE FINANCIAL CORP

## FORM 10-Q (Quarterly Report)

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Address	612 MAIN ST EMLENTON, PA 16373
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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 **June 30, 2017**

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)

**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, smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 2,205,944 at August 14, 2017.

**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 June 30, 2017 and December 31, 2016  
 (Dollar amounts in thousands, except share and per share data)

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
<b><u>Assets</u></b>		
Cash and due from banks	\$ 2,455	\$ 2,758
Interest earning deposits with banks	32,260	14,810
Cash and cash equivalents	34,715	17,568
Securities available for sale	99,828	101,560
Loans held for sale	—	68
Loans receivable, net of allowance for loan losses of \$5,767 and \$5,545	545,766	515,435
Federal bank stocks, at cost	4,862	4,861
Bank-owned life insurance	11,555	11,390
Accrued interest receivable	1,827	1,815
Premises and equipment, net	17,908	18,282
Goodwill	10,288	10,288
Core deposit intangible, net	441	560
Prepaid expenses and other assets	9,675	10,308
<b>Total Assets</b>	<b>\$ 736,865</b>	<b>\$ 692,135</b>
<b><u>Liabilities and Stockholders' Equity</u></b>		
<b>Liabilities:</b>		
Deposits:		
Non-interest bearing	\$ 129,230	\$ 123,717
Interest bearing	499,944	461,223
Total deposits	629,174	584,940
Short-term borrowed funds	2,500	9,500
Long-term borrowed funds	39,000	34,500
Accrued interest payable	359	239
Accrued expenses and other liabilities	9,185	8,883
<b>Total Liabilities</b>	<b>680,218</b>	<b>638,062</b>
<b>Commitments and Contingent Liabilities</b>		
	—	—
<b>Stockholders' Equity:</b>		
Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,302,961 and 2,254,375 shares issued; 2,200,944 and 2,152,358 shares outstanding, respectively	2,879	2,818
Additional paid-in capital	29,211	27,900
Treasury stock, at cost; 102,017 shares	(2,114)	(2,114)
Retained earnings	30,790	29,960
Accumulated other comprehensive loss	(4,119)	(4,491)
<b>Total Stockholders' Equity</b>	<b>56,647</b>	<b>54,073</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 736,865</b>	<b>\$ 692,135</b>

See accompanying notes to consolidated financial statements.



**Emclave Financial Corp**  
Consolidated Statements of Net Income (Unaudited)  
For the three and six months ended June 30, 2017 and 2016  
(Dollar amounts in thousands, except share and per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
<b>Interest and dividend income:</b>				
Loans receivable, including fees	\$ 5,801	\$ 5,185	\$ 11,367	\$ 9,887
Securities:				
Taxable	392	441	787	874
Exempt from federal income tax	140	156	283	316
Federal bank stocks	61	52	115	87
Interest earning deposits with banks	38	43	53	62
<b>Total interest and dividend income</b>	<b>6,432</b>	<b>5,877</b>	<b>12,605</b>	<b>11,226</b>
<b>Interest expense:</b>				
Deposits	749	721	1,452	1,309
Borrowed funds	318	296	632	540
<b>Total interest expense</b>	<b>1,067</b>	<b>1,017</b>	<b>2,084</b>	<b>1,849</b>
<b>Net interest income</b>	<b>5,365</b>	<b>4,860</b>	<b>10,521</b>	<b>9,377</b>
Provision for loan losses	201	121	363	302
<b>Net interest income after provision for loan losses</b>	<b>5,164</b>	<b>4,739</b>	<b>10,158</b>	<b>9,075</b>
<b>Noninterest income:</b>				
Fees and service charges	435	386	842	731
Net gain on sales of available for sale securities	350	81	350	83
Net gain on sales of loans	124	—	130	—
Other-than-temporary impairment loss	(508)	—	(508)	—
Earnings on bank-owned life insurance	101	100	202	198
Other	366	375	707	710
<b>Total noninterest income</b>	<b>868</b>	<b>942</b>	<b>1,723</b>	<b>1,722</b>
<b>Noninterest expense:</b>				
Compensation and employee benefits	2,347	2,177	4,670	4,225
Premises and equipment	726	692	1,484	1,378
Intangible asset amortization	59	56	119	105
Professional fees	216	190	417	373
Federal deposit insurance	102	89	210	182
Acquisition costs	106	92	107	401
Other	1,121	1,168	2,291	1,818
<b>Total noninterest expense</b>	<b>4,677</b>	<b>4,464</b>	<b>9,298</b>	<b>8,482</b>
<b>Income before provision for income taxes</b>	<b>1,355</b>	<b>1,217</b>	<b>2,583</b>	<b>2,315</b>
Provision for income taxes	314	287	586	583
<b>Net income</b>	<b>\$ 1,041</b>	<b>\$ 930</b>	<b>\$ 1,997</b>	<b>\$ 1,732</b>
Basic earnings per common share	\$ 0.48	\$ 0.43	\$ 0.93	\$ 0.81
Diluted earnings per common share	0.48	0.43	0.92	\$ 0.80
Average common shares outstanding - basic	2,164,747	2,146,160	2,158,587	2,145,484
Average common shares outstanding - diluted	2,182,761	2,156,378	2,175,523	2,154,708



**Emclaire Financial Corp**  
Consolidated Statements of Comprehensive Income (Unaudited)  
For the three and six months ended June 30, 2017 and 2016  
(Dollar amounts in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
Net income	\$ 1,041	\$ 930	\$ 1,997	\$ 1,732
<b>Other comprehensive income</b>				
Unrealized gains on securities:				
Unrealized holding gain arising during the period	15	699	406	2,030
Reclassification adjustment for gains included in net income	(350)	(81)	(350)	(83)
Reclassification adjustment for other than temporary impairment losses included in net income	508	—	508	—
	173	618	564	1,947
Tax effect	(59)	(210)	(192)	(662)
Net of tax	114	408	372	1,285
Comprehensive income	<u>\$ 1,155</u>	<u>\$ 1,338</u>	<u>\$ 2,369</u>	<u>\$ 3,017</u>

See accompanying notes to consolidated financial statements.



**Emclave Financial Corp**  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
For the six months ended June 30, 2017 and 2016  
(Dollar amounts in thousands)

	For the six months ended June 30,	
	2017	2016
<b>Cash flows from operating activities</b>		
Net income	\$ 1,997	\$ 1,732
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	578	550
Provision for loan losses	363	302
Amortization of premiums, net	174	176
Amortization of intangible assets and mortgage servicing rights	143	115
Impairment loss on security recognized in earnings	508	—
Realized gains on sales of available for sale securities, net	(350)	(83)
Net gains on sales of loans	(130)	—
Net gains on foreclosed real estate	—	(10)
Loans originated for sale	(3,265)	—
Proceeds from the sale of loans originated for sale	3,371	—
Stock compensation expense	110	111
Increase in bank-owned life insurance, net	(165)	(165)
Increase in accrued interest receivable	(12)	(102)
Decrease in prepaid expenses and other assets	332	75
Increase in accrued interest payable	120	46
Increase (decrease) in accrued expenses and other liabilities	302	(702)
<b>Net cash provided by operating activities</b>	<b>4,076</b>	<b>2,045</b>
<b>Cash flows from investing activities</b>		
Loan originations and principal collections, net	(32,600)	3,604
Purchase of residential mortgage loans	—	(6,911)
Proceeds from sales of loans held for sale previously classified as portfolio loans	1,817	—
Available for sale securities:		
Sales	18,195	6,118
Maturities, repayments and calls	5,850	11,060
Purchases	(21,939)	(8,258)
Net cash paid for acquisition	—	(3,309)
Redemption (purchase) of federal bank stocks	(1)	1,454
Proceeds from the sale of foreclosed real estate	124	171
Purchases of premises and equipment	(204)	(392)
<b>Net cash provided by (used in) investing activities</b>	<b>(28,758)</b>	<b>3,537</b>
<b>Cash flows from financing activities</b>		
Net increase in deposits	44,234	34,299
Repayments on long-term debt	(500)	(5,000)
Proceeds from other long-term debt	5,000	5,000
Net change in short-term borrowings	(7,000)	(11,750)
Proceeds from exercise of stock options	1,263	—
Dividends paid	(1,168)	(1,116)
<b>Net cash provided by financing activities</b>	<b>41,829</b>	<b>21,433</b>
Increase in cash and cash equivalents	17,147	27,015
Cash and cash equivalents at beginning of period	17,568	11,546
Cash and cash equivalents at end of period	<b>\$ 34,715</b>	<b>\$ 38,561</b>

<b>Supplemental information:</b>			
Interest paid	\$	1,964	\$ 942
Income taxes paid		575	—
<b>Supplemental noncash disclosure:</b>			
Transfers from loans to foreclosed real estate		39	147
Transfers from portfolio loans to loans held for sale		1,725	—

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**  
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)  
For the three and six months ended June 30, 2017 and 2016  
(Dollar amounts in thousands, except per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
<b>Balance at beginning of period</b>	\$ 54,761	\$ 54,007	\$ 54,073	\$ 52,839
Net income	1,041	930	1,997	1,732
Other comprehensive income	114	408	372	1,285
Stock compensation expense	55	64	110	111
Dividends declared on common stock	(587)	(558)	(1,168)	(1,116)
Exercise of stock options (48,586 shares)	1,263	—	1,263	—
<b>Balance at end of period</b>	<u>\$ 56,647</u>	<u>\$ 54,851</u>	<u>\$ 56,647</u>	<u>\$ 54,851</u>
Cash dividend per common share	<u>\$ 0.27</u>	<u>\$ 0.26</u>	<u>\$ 0.54</u>	<u>\$ 0.52</u>

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, 2016, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016 filed with the SEC.

The balance sheet at December 31, 2016 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements.

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

**2. Mergers and Acquisitions**

On May 4, 2017, the Corporation and Northern Hancock Bank & Trust Co. (Northern Hancock) announced that they have entered into an Agreement and Plan of Merger providing for the acquisition of Northern Hancock by the Corporation. Northern Hancock is a West Virginia bank headquartered in Newall, West Virginia and operates two offices located in Hancock County, West Virginia.

Under the terms of the merger agreement, Northern Hancock will merge into the Bank and shareholders of Northern Hancock will receive 0.9793 of a share of the Corporation's common stock and \$3.35 in cash for each share of common stock of Northern Hancock upon completion of the merger or approximately \$1.7 million of stock and \$200,000 in cash in the aggregate. The merger is expected to be completed in the third quarter of 2017, subject to the satisfaction of customary closing conditions, including regulatory approval and the approval of the shareholders of Northern Hancock.

### 3. 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:

<i>(Dollar amounts in thousands, except for per share amounts)</i>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
<b>Earnings per common share - basic</b>				
Net income	\$ 1,041	\$ 930	\$ 1,997	\$ 1,732
Average common shares outstanding	2,164,747	2,146,160	2,158,587	2,145,484
Basic earnings per common share	\$ 0.48	\$ 0.43	\$ 0.93	\$ 0.81
<b>Earnings per common share - diluted</b>				
Net income	\$ 1,041	\$ 930	\$ 1,997	\$ 1,732
Average common shares outstanding	2,164,747	2,146,160	2,158,587	2,145,484
Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options	18,014	10,218	16,936	9,224
Average shares and dilutive potential common shares	2,182,761	2,156,378	2,175,523	2,154,708
Diluted earnings per common share	\$ 0.48	\$ 0.43	\$ 0.92	\$ 0.80
Stock options not considered in computing earnings per share because they were antidilutive	—	67,000	—	67,000

#### 4. Securities

The following table summarizes the Corporation's securities as of June 30, 2017 and December 31, 2016 :

*(Dollar amounts in thousands)*

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for sale:</b>				
<b>June 30, 2017:</b>				
U.S. Treasury and federal agency	\$ 4,545	\$ —	\$ (27)	\$ 4,518
U.S. government sponsored entities and agencies	12,151	3	(111)	12,043
U.S. agency mortgage-backed securities: residential	22,303	33	(94)	22,242
U.S. agency collateralized mortgage obligations: residential	24,538	28	(564)	24,002
State and political subdivisions	25,662	150	(31)	25,781
Corporate debt securities	9,512	28	(20)	9,520
Equity securities	1,580	160	(18)	1,722
	<u>\$ 100,291</u>	<u>\$ 402</u>	<u>\$ (865)</u>	<u>\$ 99,828</u>
<b>December 31, 2016:</b>				
U.S. Treasury and federal agency	4,550	—	(50)	4,500
U.S. government sponsored entities and agencies	9,186	—	(188)	8,998
U.S. agency mortgage-backed securities: residential	25,790	32	(196)	25,626
U.S. agency collateralized mortgage obligations: residential	25,367	23	(684)	24,706
State and political subdivisions	27,853	17	(262)	27,608
Corporate debt securities	8,012	5	(85)	7,932
Equity securities	1,829	373	(12)	2,190
	<u>\$ 102,587</u>	<u>\$ 450</u>	<u>\$ (1,477)</u>	<u>\$ 101,560</u>

The following table summarizes scheduled maturities of the Corporation's debt securities as of June 30, 2017 . 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	\$ 3,158	\$ 3,155
Due after one year through five years	27,945	27,873
Due after five through ten years	19,756	19,835
Due after ten years	1,011	999
Mortgage-backed securities: residential	22,303	22,242
Collateralized mortgage obligations: residential	24,538	24,002
	<u>\$ 98,711</u>	<u>\$ 98,106</u>

#### 4. Securities (continued)

Information pertaining to securities with gross unrealized losses at June 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>June 30, 2017:</b>						
U.S. Treasury and federal agency	\$ 4,518	\$ (27)	\$ —	\$ —	\$ 4,518	\$ (27)
U.S. government sponsored entities and agencies	9,054	(111)	—	—	9,054	(111)
U.S. agency mortgage-backed securities: residential	11,446	(94)	—	—	11,446	(94)
U.S. agency collateralized mortgage obligations: residential	9,481	(184)	12,694	(380)	22,175	(564)
State and political subdivisions	3,863	(28)	347	(3)	4,210	(31)
Corporate debt securities	4,995	(20)	—	—	4,995	(20)
Equity securities	—	—	231	(18)	231	(18)
	<u>\$ 43,357</u>	<u>\$ (464)</u>	<u>\$ 13,272</u>	<u>\$ (401)</u>	<u>\$ 56,629</u>	<u>\$ (865)</u>
<b>December 31, 2016:</b>						
U.S. Treasury and federal agency	\$ 4,500	\$ (50)	\$ —	\$ —	\$ 4,500	\$ (50)
U.S. government sponsored entities and agencies	8,998	(188)	—	—	8,998	(188)
U.S. agency mortgage-backed securities: residential	23,279	(196)	—	—	23,279	(196)
U.S. agency collateralized mortgage obligations: residential	13,568	(438)	9,317	(246)	22,885	(684)
State and political subdivisions	21,924	(262)	—	—	21,924	(262)
Corporate debt securities	3,927	(85)	—	—	3,927	(85)
Equity securities	—	—	237	(12)	237	(12)
	<u>\$ 76,196</u>	<u>\$ (1,219)</u>	<u>\$ 9,554</u>	<u>\$ (258)</u>	<u>\$ 85,750</u>	<u>\$ (1,477)</u>

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

Description of Securities	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
Proceeds	\$ 18,195	\$ 2,439	\$ 18,195	\$ 6,118
Gains	350	81	350	83
Tax provision related to gains	119	28	119	28

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.

#### 4. Securities (continued)

There was one equity security in an unrealized loss position for more than 12 months as of June 30, 2017. Equity securities owned by the Corporation consist of common stock of various financial service providers. This investment security is in an unrealized loss position as a result of the illiquid nature of the stock. 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 in the near future. 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 June 30, 2017 to be other-than-temporarily impaired.

During the three months ended June 30, 2017, management determined that an other-than-temporary impairment existed on a corporate debt security due to deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest. This security was written down to its fair market value and the resulting impairment loss of \$508,000 was recognized in earnings during the quarter ended June 30, 2017.

After recognizing the aforementioned impairment, there were 69 debt securities in an unrealized loss position as of June 30, 2017, of which 14 were in an unrealized loss position for more than 12 months. Of these 69 securities, 25 were government-backed collateralized mortgage obligations, 12 were state and political subdivision securities, 10 were corporate securities, 9 were mortgage-backed securities, 8 were U.S. government sponsored entity and agency securities and 5 were U.S. Treasury securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider these debt securities with unrealized losses as of June 30, 2017 to be other-than-temporarily impaired.



## 5. Loans Receivable and Related Allowance for Loan Losses

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

<i>(Dollar amounts in thousands)</i>	<b>June 30, 2017</b>	<b>December 31, 2016</b>
<b>Mortgage loans on real estate:</b>		
Residential first mortgages	\$ 214,905	\$ 198,167
Home equity loans and lines of credit	90,736	91,359
Commercial real estate	179,891	166,994
	<u>485,532</u>	<u>456,520</u>
<b>Other loans:</b>		
Commercial business	58,797	57,788
Consumer	7,204	6,672
	<u>66,001</u>	<u>64,460</u>
<b>Total loans, gross</b>	551,533	520,980
<b>Less allowance for loan losses</b>	5,767	5,545
<b>Total loans, net</b>	<u>\$ 545,766</u>	<u>\$ 515,435</u>

During the quarter ended June 30, 2017, the Corporation sold \$1.1 million of residential mortgage loans that were previously classified as held for investment.

Included in total loans above are net deferred costs of \$1.4 million and \$1.3 million at June 30, 2017 and December 31, 2016, respectively.

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

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

At June 30, 2017, there was no allowance for loan losses allocated to loans acquired in the April 2016 merger with United American Savings Bank.

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

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

	<i>(Dollar amounts in thousands)</i>					
	Residential Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
<b>Three months ended June 30, 2017:</b>						
Allowance for loan losses:						
Beginning Balance	\$ 1,956	\$ 648	\$ 2,449	\$ 583	\$ 52	\$ 5,688
Charge-offs	(10)	(10)	(90)	(10)	(8)	(128)
Recoveries	—	1	2	—	3	6
Provision	48	—	99	48	6	201
Ending Balance	<u>\$ 1,994</u>	<u>\$ 639</u>	<u>\$ 2,460</u>	<u>\$ 621</u>	<u>\$ 53</u>	<u>\$ 5,767</u>
<b>Six months ended June 30, 2017:</b>						
Allowance for loan losses:						
Beginning Balance	\$ 1,846	\$ 633	\$ 2,314	\$ 700	\$ 52	\$ 5,545
Charge-offs	(36)	(11)	(90)	(10)	(27)	(174)
Recoveries	—	20	4	—	9	33
Provision	184	(3)	232	(69)	19	363
Ending Balance	<u>\$ 1,994</u>	<u>\$ 639</u>	<u>\$ 2,460</u>	<u>\$ 621</u>	<u>\$ 53</u>	<u>\$ 5,767</u>
<b>At June 30, 2017:</b>						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	\$ 8	\$ —	\$ —	\$ —	\$ —	\$ 8
Acquired loans collectively evaluated for impairment	—	—	—	—	—	—
Originated loans collectively evaluated for impairment	1,986	639	2,460	621	53	5,759
Total	<u>\$ 1,994</u>	<u>\$ 639</u>	<u>\$ 2,460</u>	<u>\$ 621</u>	<u>\$ 53</u>	<u>\$ 5,767</u>
Total loans:						
Individually evaluated for impairment	\$ 442	\$ —	\$ 975	\$ 600	\$ —	\$ 2,017
Acquired loans collectively evaluated for impairment	21,849	4,324	24,486	1,038	—	51,697
Originated loans collectively evaluated for impairment	192,614	86,412	154,430	57,159	7,204	497,819
Total	<u>\$ 214,905</u>	<u>\$ 90,736</u>	<u>\$ 179,891</u>	<u>\$ 58,797</u>	<u>\$ 7,204</u>	<u>\$ 551,533</u>
<b>At December 31, 2016:</b>						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	\$ 19	\$ —	\$ 95	\$ 6	\$ —	\$ 120
Acquired loans collectively evaluated for impairment	—	—	—	—	—	—
Originated loans collectively evaluated for impairment	1,827	633	2,219	694	52	5,425
Total	<u>\$ 1,846</u>	<u>\$ 633</u>	<u>\$ 2,314</u>	<u>\$ 700</u>	<u>\$ 52</u>	<u>\$ 5,545</u>
Total loans:						
Individually evaluated for impairment	\$ 135	\$ —	\$ 1,014	\$ 684	\$ —	\$ 1,833
Acquired loans collectively evaluated for impairment	25,024	5,225	27,492	1,182	13	58,936
Originated loans collectively evaluated for impairment	173,008	86,134	138,488	55,922	6,659	460,211
Total	<u>\$ 198,167</u>	<u>\$ 91,359</u>	<u>\$ 166,994</u>	<u>\$ 57,788</u>	<u>\$ 6,672</u>	<u>\$ 520,980</u>
<b>Three months ended June 30, 2016:</b>						
Allowance for loan losses:						
Beginning Balance	\$ 1,577	\$ 636	\$ 1,926	\$ 1,162	\$ 51	\$ 5,352
Charge-offs	(8)	(33)	—	—	(6)	(47)
Recoveries	—	1	3	—	1	5

Provision	127	41	189	(242)	6	121
Ending Balance	\$ 1,696	\$ 645	\$ 2,118	\$ 920	\$ 52	\$ 5,431

**Six months ended June 30, 2016:**

Allowance for loan losses:

Beginning Balance	\$ 1,429	\$ 586	\$ 2,185	\$ 960	\$ 45	\$ 5,205
Charge-offs	(40)	(33)	—	—	(15)	(88)
Recoveries	—	1	7	—	4	12
Provision	307	91	(74)	(40)	18	302
Ending Balance	\$ 1,696	\$ 645	\$ 2,118	\$ 920	\$ 52	\$ 5,431

## 5. 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 June 30, 2017 :

<i>(Dollar amounts in thousands)</i>						
Impaired Loans with Specific Allowance						
	As of June 30, 2017			For the three months ended June 30, 2017		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ 76	\$ 76	\$ 8	\$ 76	\$ 1	\$ 1
Home equity and lines of credit	—	—	—	—	—	—
Commercial real estate	—	—	—	—	—	—
Commercial business	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$ 76</b>	<b>\$ 76</b>	<b>\$ 8</b>	<b>\$ 76</b>	<b>\$ 1</b>	<b>\$ 1</b>
For the six months ended June 30, 2017						
				Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages				\$ 96	\$ 2	\$ 2
Home equity and lines of credit				—	—	—
Commercial real estate				186	—	—
Commercial business				196	—	—
Consumer				—	—	—
<b>Total</b>				<b>\$ 478</b>	<b>\$ 2</b>	<b>\$ 2</b>
Impaired Loans with No Specific Allowance						
	As of June 30, 2017		For the three months ended June 30, 2017			
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages	\$ 478	\$ 366	\$ 369	\$ 3	\$ 3	
Home equity and lines of credit	—	—	—	—	—	
Commercial real estate	1,149	975	983	—	—	
Commercial business	600	600	620	—	—	
Consumer	—	—	—	—	—	
<b>Total</b>	<b>\$ 2,227</b>	<b>\$ 1,941</b>	<b>\$ 1,972</b>	<b>\$ 3</b>	<b>\$ 3</b>	
For the six months ended June 30, 2017						
			Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages			\$ 246	\$ 4	\$ 4	
Home equity and lines of credit			—	—	—	
Commercial real estate			807	1	1	
Commercial business			446	1	1	
Consumer			—	—	—	

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Total	\$	1,499	\$	6	\$	6
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## 5. 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, 2016 :

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance					
	As of December 31, 2016			For the year ended December 31, 2016		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ 168	\$ 135	\$ 19	\$ 119	\$ 6	\$ 6
Home equity and lines of credit	—	—	—	—	—	—
Commercial real estate	557	557	95	130	23	—
Commercial business	588	588	6	428	—	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$ 1,313</b>	<b>\$ 1,280</b>	<b>\$ 120</b>	<b>\$ 677</b>	<b>\$ 29</b>	<b>\$ 6</b>

	Impaired Loans with No Specific Allowance					
	As of December 31, 2016			For the year ended December 31, 2016		
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages	—	—	23	—	—	
Home equity and lines of credit	—	—	—	—	—	
Commercial real estate	631	457	735	3	3	
Commercial business	96	96	322	2	2	
Consumer	—	—	—	—	—	
<b>Total</b>	<b>727</b>	<b>553</b>	<b>1,080</b>	<b>5</b>	<b>5</b>	

## 5. 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 June 30, 2016 :

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance					
	As of June 30, 2016			For the three months ended June 30, 2016		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ 78	\$ 78	\$ 19	\$ 78	\$ 1	\$ 1
Home equity and lines of credit	—	—	—	—	—	—
Commercial real estate	—	—	—	—	—	—
Commercial business	—	—	—	315	—	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$ 78</b>	<b>\$ 78</b>	<b>\$ 19</b>	<b>\$ 393</b>	<b>\$ 1</b>	<b>\$ 1</b>
	For the six months ended June 30, 2016					
				Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages				\$ 109	\$ 2	\$ 2
Home equity and lines of credit				—	—	—
Commercial real estate				31	—	—
Commercial business				517	—	—
Consumer				—	—	—
<b>Total</b>				<b>\$ 657</b>	<b>\$ 2</b>	<b>\$ 2</b>
	Impaired Loans with No Specific Allowance					
	As of June 30, 2016			For the three months ended June 30, 2016		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ 91	\$ 58	\$ —	\$ 58	\$ —	\$ —
Home equity and lines of credit	—	—	—	—	—	—
Commercial real estate	1,222	823	—	840	—	—
Commercial business	690	690	—	382	1	1
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$ 2,003</b>	<b>\$ 1,571</b>	<b>\$ —</b>	<b>\$ 1,280</b>	<b>\$ 1</b>	<b>\$ 1</b>
	For the six months ended June 30, 2016					
				Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages				\$ 38	\$ 2	\$ 2
Home equity and lines of credit				—	—	—
Commercial real estate				809	1	1
Commercial business				280	1	1
Consumer				—	—	—

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Total	\$	1,127	\$	4	\$	4
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## 5. Loans Receivable and Related Allowance for Loan Losses (continued)

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

**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 June 30, 2017 and December 31, 2016, the Corporation had \$537,000 and \$239,000, respectively, of loans classified as TDRs, which are included in impaired loans above. The Corporation had allocated \$8,000 and \$19,000 of specific allowance for these loans at June 30, 2017 and December 31, 2016, respectively.

The Corporation did not modify any loans as TDRs during the three month period ended June 30, 2017. During the six month period ended June 30, 2017, the Corporation modified one residential mortgage loan with a recorded investment of \$323,000 due to a bankruptcy order. At June 30, 2017, the Corporation did not have any allowance for loan losses allocated to this specific loan. The modification did not have a material impact on the Corporation's income statement during the periods. During the three and six month period ended June 30, 2016, the Corporation modified one home equity loan with a recorded investment of \$10,000 due to a bankruptcy order. At June 30, 2016, the Corporation did not have any specific allowance for loan losses allocated to this specific loan.

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 six month periods ended June 30, 2017 and 2016, the Corporation did not have any loans which were modified as TDRs for which there was a payment default within twelve months following the modification.

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

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

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

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

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

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

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

Management uses the following definitions for risk ratings:

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

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

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

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

The following table presents the classes of the loan portfolio summarized by the aggregate pass and the criticized categories of special mention, substandard and doubtful within the Corporation's internal risk rating system as of June 30, 2017 and December 31, 2016 :

(Dollar amounts in thousands)

	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
<b>June 30, 2017:</b>						
Residential first mortgages	\$ 213,966	\$ —	\$ —	\$ 939	\$ —	\$ 214,905
Home equity and lines of credit	90,231	—	—	505	—	90,736
Commercial real estate	—	173,291	1,199	5,401	—	179,891
Commercial business	—	57,130	537	1,130	—	58,797
Consumer	7,204	—	—	—	—	7,204
<b>Total</b>	<b>\$ 311,401</b>	<b>\$ 230,421</b>	<b>\$ 1,736</b>	<b>\$ 7,975</b>	<b>\$ —</b>	<b>\$ 551,533</b>
<b>December 31, 2016:</b>						
Residential first mortgages	\$ 197,041	\$ —	\$ —	\$ 1,126	\$ —	\$ 198,167
Home equity and lines of credit	91,017	—	—	342	—	91,359
Commercial real estate	—	161,312	1,077	4,605	—	166,994
Commercial business	—	52,125	4,926	737	—	57,788
Consumer	6,659	—	—	13	—	6,672
<b>Total</b>	<b>\$ 294,717</b>	<b>\$ 213,437</b>	<b>\$ 6,003</b>	<b>\$ 6,823</b>	<b>\$ —</b>	<b>\$ 520,980</b>

## 5. 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 June 30, 2017 and December 31, 2016 :

*(Dollar amounts in thousands)*

	Performing			Nonperforming		Total
	Accruing Loans Not Past Due	Accruing 30-59 Days Past Due	Accruing 60-89 Days Past Due	Accruing 90+ Days Past Due	Nonaccrual	
<b>June 30, 2017:</b>						
Residential first mortgages	\$ 211,336	\$ 1,814	\$ 816	\$ 180	\$ 759	\$ 214,905
Home equity and lines of credit	89,865	353	13	54	451	90,736
Commercial real estate	178,089	790	11	—	1,001	179,891
Commercial business	57,837	323	37	—	600	58,797
Consumer	7,167	28	9	—	—	7,204
<b>Total loans</b>	<b>\$ 544,294</b>	<b>\$ 3,308</b>	<b>\$ 886</b>	<b>\$ 234</b>	<b>\$ 2,811</b>	<b>\$ 551,533</b>
<b>December 31, 2016:</b>						
Residential first mortgages	\$ 194,830	\$ 1,916	\$ 295	\$ —	\$ 1,126	\$ 198,167
Home equity and lines of credit	90,557	460	—	2	340	91,359
Commercial real estate	165,318	561	—	42	1,073	166,994
Commercial business	56,972	56	34	—	726	57,788
Consumer	6,602	28	29	—	13	6,672
<b>Total loans</b>	<b>\$ 514,279</b>	<b>\$ 3,021</b>	<b>\$ 358</b>	<b>\$ 44</b>	<b>\$ 3,278</b>	<b>\$ 520,980</b>

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

The following table presents the Corporation's nonaccrual loans by aging category as of June 30, 2017 and December 31, 2016 :

*(Dollar amounts in thousands)*

	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total
<b>June 30, 2017:</b>					
Residential first mortgages	\$ 71	\$ 388	\$ —	\$ 300	\$ 759
Home equity and lines of credit	—	—	17	434	451
Commercial real estate	369	—	—	632	1,001
Commercial business	600	—	—	—	600
Consumer	—	—	—	—	—
<b>Total loans</b>	<b>\$ 1,040</b>	<b>\$ 388</b>	<b>\$ 17</b>	<b>\$ 1,366</b>	<b>\$ 2,811</b>
<b>December 31, 2016:</b>					
Residential first mortgages	72	77	—	977	1,126
Home equity and lines of credit	—	—	—	340	340
Commercial real estate	397	—	557	119	1,073
Commercial business	631	—	—	95	726
Consumer	—	—	—	13	13
<b>Total loans</b>	<b>\$ 1,100</b>	<b>\$ 77</b>	<b>\$ 557</b>	<b>\$ 1,544</b>	<b>\$ 3,278</b>

## 6. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of June 30, 2017 and December 31, 2016 :

*(Dollar amounts in thousands)*

	June 30, 2017		December 31, 2016	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$ 10,288	\$ —	\$ 10,288	\$ —
Core deposit intangibles	4,259	3,818	4,259	3,699
<b>Total</b>	<b>\$ 14,547</b>	<b>\$ 3,818</b>	<b>\$ 14,547</b>	<b>\$ 3,699</b>

Goodwill resulted from four acquisitions. During 2016, the Corporation recorded \$6.6 million of goodwill related to the acquisition of United American Savings Bank. Goodwill represents the excess of the total purchase price paid for the acquisitions over the fair value of the identifiable assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. The Corporation has selected November 30 as the date to perform the annual impairment test. No goodwill impairment charges were recorded during 2016 or in the first six months of 2017 .

The core deposit intangible asset, resulting from two acquisitions, is amortized using the double declining balance method over a weighted average estimated life of the related deposits and is not estimated to have a significant residual value. During the three and six month periods ending June 30, 2017 , the Corporation recorded intangible amortization expense totaling \$59,000 and \$119,000 , respectively, compared to \$56,000 and \$105,000 , respectively for the same periods in 2016 .

## 7. Stock Compensation Plan

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 June 30, 2017, 65,783 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, permitted 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 June 30, 2017, no additional shares of stock may be issued as the plan expired on June 20, 2017.

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 June 30, 2017, 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, 2017	62,000	\$ 25.71	\$ 219	0.6
Granted	—	—	—	—
Exercised	(48,586)	25.99	80	—
Forfeited	—	—	—	—
Expired	(8,414)	26.00	—	—
Outstanding as of June 30, 2017	<u>5,000</u>	<u>\$ 22.50</u>	<u>\$ 27</u>	<u>1.4</u>
Exercisable as of June 30, 2017	<u>5,000</u>	<u>\$ 22.50</u>	<u>\$ 27</u>	<u>1.4</u>

A summary of the status of the Corporation's nonvested restricted stock awards as of June 30, 2017, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2017	26,900	\$ 25.09
Granted	—	—
Vested	—	—
Forfeited	—	—
Nonvested as of June 30, 2017	<u>26,900</u>	<u>\$ 25.09</u>

For the three and six month periods ended June 30, 2017, the Corporation recognized stock compensation expense of \$55,000 and \$110,000, respectively, compared to \$64,000 and \$111,000, respectively, for the same periods in 2016. As of June 30, 2017, there was \$370,000 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 1.6 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.

## 8. Fair Value

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sale transaction or exit price on the date indicated. The estimated fair value amounts have been measured as of their respective dates and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported.

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 the fair value of each type of financial instrument:

*Cash and cash equivalents* – The carrying value of cash, due from banks and interest bearing deposits 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.

*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.

## 8. Fair Value (continued)

*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 June 30, 2017, the Corporation did not have any impaired loans carried at fair value measured using the fair value of collateral, compared to loan balances of \$1.2 million, net of a valuation allowance of \$120,000, at December 31, 2016. There was no additional provision for loan losses recorded for impaired loans during the three and six month periods ended June 30, 2017 and 2016.

*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 June 30, 2017 and December 31, 2016, the Corporation had no OREO measured at fair value. There was no expense recorded during the three and six month periods ended June 30, 2017 and 2016 associated with the write-down of OREO.

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

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

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

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

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

## 8. Fair Value (continued)

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

Description	Total	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
<i>(Dollar amounts in thousands)</i>				
<b>June 30, 2017:</b>				
U.S. Treasury and federal agency	\$ 4,518	\$ 4,518	\$ —	\$ —
U.S. government sponsored entities and agencies	12,043	—	12,043	—
U.S. agency mortgage-backed securities: residential	22,242	—	22,242	—
U.S. agency collateralized mortgage obligations: residential	24,002	—	24,002	—
State and political subdivision	25,781	—	25,781	—
Corporate debt securities	9,520	—	9,520	—
Equity securities	1,722	1,587	—	135
	<u>\$ 99,828</u>	<u>\$ 6,105</u>	<u>\$ 93,588</u>	<u>\$ 135</u>
<b>December 31, 2016:</b>				
U.S. Treasury and federal agency	4,500	4,500	—	—
U.S. government sponsored entities and agencies	8,998	—	8,998	—
U.S. agency mortgage-backed securities: residential	25,626	—	25,626	—
U.S. agency collateralized mortgage obligations: residential	24,706	—	24,706	—
State and political subdivisions	27,608	—	27,608	—
Corporate debt securities	7,932	—	7,932	—
Equity securities	2,190	2,054	—	136
	<u>\$ 101,560</u>	<u>\$ 6,554</u>	<u>\$ 94,870</u>	<u>\$ 136</u>

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 six month periods ended June 30, 2017 and 2016, 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 six month periods ended June 30, 2017 and 2016:

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
<i>(Dollar amounts in thousands)</i>				
Balance at the beginning of the period	\$ 136	\$ 74	\$ 136	\$ 74
Total gains or losses (realized/unrealized):				
Included in earnings	—	—	—	—
Included in other comprehensive income	(1)	1	(1)	1
Acquired	—	60	—	60
Transfers in and/or out of Level 3	—	—	—	—
Balance at the end of the period	<u>\$ 135</u>	<u>\$ 135</u>	<u>\$ 135</u>	<u>\$ 135</u>



## 8. Fair Value (continued)

The Corporation had no assets measured at fair value on a non-recurring basis at June 30, 2017. For assets measured at fair value on a non-recurring basis at December 31, 2016, the fair value measurements by level within the fair value hierarchy are as follows:

<i>(Dollar amounts in thousands)</i>		(Level 1)	(Level 2)	(Level 3)
Description	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
<b>December 31, 2016:</b>				
Impaired residential mortgage loan	\$ 58	\$ —	\$ —	\$ 58
Impaired commercial real estate loan	463			463
Impaired commercial business loan	582	—	—	582
	<u>\$ 1,103</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,103</u>

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

<i>(Dollar amounts in thousands)</i>		Valuation Technique(s)	Unobservable Input(s)	Weighted Average
<b>December 31, 2016:</b>				
Impaired residential mortgage loan	\$ 58	Sales comparison approach	Adjustment for differences between comparable sales	10%
Impaired commercial real estate loan	463	Sales comparison approach	Adjustment for differences between comparable sales	37%
Impaired commercial business loan	582	Liquidation value of business assets	Adjustment for differences between comparable business assets	64%

Excluded from the tables above at December 31, 2016 was an impaired residential mortgage loan totaling \$58,000 classified as a TDR which was measured using a discounted cash flow methodology.

## 8. 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 June 30, 2017 and December 31, 2016 :

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Measurements using:			
		Total	Level 1	Level 2	Level 3
<b>June 30, 2017:</b>					
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 34,715	\$ 34,715	\$ 34,715	\$ —	\$ —
Securities available for sale	99,828	99,828	6,105	93,588	135
Loans held for sale	—	—	—	—	—
Loans, net	545,766	547,265	—	—	547,265
Federal bank stock	4,862	—	N/A	N/A	N/A
Accrued interest receivable	1,827	1,827	53	335	1,439
	<u>\$ 686,998</u>	<u>\$ 683,635</u>	<u>\$ 40,873</u>	<u>\$ 93,923</u>	<u>\$ 548,839</u>
<b>Financial Liabilities:</b>					
Deposits	629,174	631,082	461,889	169,193	—
Borrowed funds	41,500	41,377	—	41,377	—
Accrued interest payable	359	359	8	351	—
	<u>\$ 671,033</u>	<u>\$ 672,818</u>	<u>\$ 461,897</u>	<u>\$ 210,921</u>	<u>\$ —</u>
<b>December 31, 2016:</b>					
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 17,568	\$ 17,568	\$ 17,568	\$ —	\$ —
Securities available for sale	101,560	101,560	6,554	94,870	136
Loans held for sale	68	68	—	68	—
Loans, net	515,435	519,573	—	—	519,573
Federal bank stock	4,861	—	N/A	N/A	N/A
Accrued interest receivable	1,815	1,815	37	365	1,413
	<u>\$ 641,307</u>	<u>\$ 640,584</u>	<u>\$ 24,159</u>	<u>\$ 95,303</u>	<u>\$ 521,122</u>
<b>Financial Liabilities:</b>					
Deposits	584,940	582,458	423,693	158,765	—
Borrowed funds	44,000	44,027	—	44,027	—
Accrued interest payable	239	239	7	232	—
	<u>\$ 629,179</u>	<u>\$ 626,724</u>	<u>\$ 423,700</u>	<u>\$ 203,024</u>	<u>\$ —</u>

## 9. Regulatory Matters

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action.

## 9. Regulatory Matters (continued)

In 2015, the Board of Governors of the Federal Reserve System amended its Small Bank Holding Company Policy Statement by increasing the policy's consolidated assets threshold from \$500 million to \$1 billion. The primary benefit of being deemed a "small bank holding company" is the exemption from the requirement to maintain consolidated regulatory capital ratios; instead, regulatory capital ratios only apply at the subsidiary bank level.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (BASEL III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the BASEL III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2017 is 1.25% and was 0.625% for 2016. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of June 30, 2017, the Bank meets all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At June 30, 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

The following table sets forth certain information concerning the Bank's regulatory capital as of the dates presented. The capital adequacy ratios disclosed below are exclusive of the capital conservation buffer.

<i>(Dollar amounts in thousands)</i>	June 30, 2017		December 31, 2016	
	Amount	Ratio	Amount	Ratio
<b>Total capital to risk-weighted assets:</b>				
Actual	\$ 60,628	12.47%	\$ 58,605	12.69%
For capital adequacy purposes	38,880	8.00%	36,945	8.00%
To be well capitalized	48,600	10.00%	46,181	10.00%
<b>Tier 1 capital to risk-weighted assets:</b>				
Actual	\$ 54,855	11.29%	\$ 53,050	11.49%
For capital adequacy purposes	29,160	6.00%	27,709	6.00%
To be well capitalized	38,880	8.00%	36,945	8.00%
<b>Common Equity Tier 1 capital to risk-weighted assets:</b>				
Actual	\$ 54,855	11.29%	\$ 53,050	11.49%
For capital adequacy purposes	21,870	4.50%	20,781	4.50%
To be well capitalized	31,590	6.50%	30,018	6.50%
<b>Tier 1 capital to average assets:</b>				
Actual	\$ 54,855	7.78%	\$ 53,050	7.84%
For capital adequacy purposes	28,215	4.00%	27,081	4.00%
To be well capitalized	35,269	5.00%	33,852	5.00%

## 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 June 30, 2017 and 2016 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 April 1, 2017	\$ (421)	\$ (3,812)	\$ (4,233)
Other comprehensive income before reclassification	10	—	10
Amounts reclassified from accumulated other comprehensive income (loss)	104	—	104
Net current period other comprehensive income	114	—	114
Accumulated Other Comprehensive Income (Loss) at June 30, 2017	\$ (307)	\$ (3,812)	\$ (4,119)

*(Dollar amounts in thousands)*

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Income For the three months ended June 30, 2017	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 350	Net gain on sale of available-for-sale securities
Unrealized gains and losses on available-for-sale securities	(508)	Other than temporary impairment losses
	54	Provision for income taxes
Total reclassifications for the period	\$ (104)	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 (Loss) at April 1, 2016	\$ 630	\$ (3,514)	\$ (2,884)
Other comprehensive income before reclassification	461	—	461
Amounts reclassified from accumulated other comprehensive income (loss)	(53)	—	(53)
Net current period other comprehensive income	408	—	408
Accumulated Other Comprehensive Income (Loss) at June 30, 2016	\$ 1,038	\$ (3,514)	\$ (2,476)

## 10. Accumulated Other Comprehensive Income (Loss) (continued)

(Dollar amounts in thousands)

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Income For the three months ended June 30, 2016	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 81	Net gain on sale of available-for-sale securities
	(28)	Provision for income taxes
Total reclassifications for the period	<u>\$ 53</u>	Net of tax

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the six months ended June 30, 2017 and 2016 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 January 1, 2017	\$ (679)	\$ (3,812)	\$ (4,491)
Other comprehensive income before reclassification	268	—	268
Amounts reclassified from accumulated other comprehensive income (loss)	104	—	104
Net current period other comprehensive income	<u>372</u>	<u>—</u>	<u>372</u>
Accumulated Other Comprehensive Income (Loss) at June 30, 2017	<u>\$ (307)</u>	<u>\$ (3,812)</u>	<u>\$ (4,119)</u>

(Dollar amounts in thousands)

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Income For the six months ended June 30, 2017	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 350	Net gain on sale of available-for-sale securities
Unrealized gains and losses on available-for-sale securities	(508)	Other than temporary impairment losses
	54	Provision for income taxes
Total reclassifications for the period	<u>\$ (104)</u>	Net of tax

## 10. Accumulated Other Comprehensive Income (Loss) (continued)

<i>(Dollar amounts in thousands)</i>	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income (Loss) at January 1, 2016	\$ (247)	\$ (3,514)	\$ (3,761)
Other comprehensive income before reclassification	1,340	—	1,340
Amounts reclassified from accumulated other comprehensive income (loss)	(55)	—	(55)
Net current period other comprehensive income	1,285	—	1,285
Accumulated Other Comprehensive Income (Loss) at June 30, 2016	<u>\$ 1,038</u>	<u>\$ (3,514)</u>	<u>\$ (2,476)</u>

*(Dollar amounts in thousands)*

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Income For the six months ended June 30, 2016	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 83	Net gain on sale of available-for-sale securities
	(28)	Provision for income taxes
Total reclassifications for the period	<u>\$ 55</u>	Net of tax

## 11. Recent Accounting Pronouncements

### Newly Issued Not Yet Effective Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-9 “Revenue from Contracts with Customers”. ASU 2014-9 provides guidance that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of this standard to annual and interim periods beginning after December 15, 2017; however, early adoption is permitted for annual and interim reporting periods beginning after December 15, 2016. ASU 2014-9 is not expected to have a significant impact on the Corporation's interest income, as our financial instruments are not within the scope of this standard, or fee-based income. We will continue to evaluate the impact of this standard.

In January 2016, the FASB issued ASU 2016-1 “Recognition and Measurement of Financial Assets and Financial Liabilities”. ASU 2016-1 revises the accounting for the classification and measurement of investments in equity securities and revises the presentation of certain fair value changes for financial liabilities measured at fair value. For equity securities, the guidance in ASU 2016-1 requires equity investments to be measured at fair value with changes in fair value recognized in net income. For financial liabilities that are measured at fair value in accordance with the fair value option, the guidance requires presenting in other comprehensive income the change in fair value that relates to a change in instrument-specific credit risk. ASU 2016-1 also eliminates the disclosure assumptions used to estimate fair value for financial instruments measured at amortized cost and requires disclosure of an exit price notion in determining the fair value of financial instruments measured at amortized cost. ASU 2016-1 is effective for interim and annual periods beginning after December 15, 2017. ASU 2016-1 is not expected to have a significant impact on the Corporation's financial statements.

## 11. Recent Accounting Pronouncements (continued)

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

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

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

In January 2017, FASB ASU 2017-04, "Simplifying the Test for Goodwill Impairment". This ASU simplifies the measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Instead, under this amendment, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss should not exceed the total amount of goodwill allocated to that reporting unit. The amendments are effective for public business entities for the first interim and annual reporting periods beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Corporation has goodwill from prior business combinations and performs an annual impairment test or more frequently if changes or circumstances occur that would more likely than not reduce the fair value of the reporting unit below its carrying value. The Corporation's most recent annual impairment assessment determined that the Corporation's goodwill was not impaired. Although the Corporation cannot anticipate future goodwill impairment assessments, based on the most recent assessment it is unlikely that an impairment amount would need to be calculated and, therefore, does not anticipate a material impact from these amendments to the Corporation's financial position and results of operations. The current accounting policies and processes are not anticipated to change, except for the elimination of the Step 2 analysis.

In March 2017, the FASB issued ASU 2017-07, "Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this update require that an employer disaggregate the service cost component from the other components of net benefit cost. The amendments also provide explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement and allow only the service cost component of net benefit cost to be eligible for capitalization. The amendments in this update improve the consistency, transparency, and usefulness of financial information to users that have communicated that the service cost component generally is analyzed differently from the other components of net benefit cost. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. The Corporation is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

## 11. Recent Accounting Pronouncements (continued)

In March 2017, the FASB issued ASU 2017-08, "Receivable - Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities." ASU 2017-08 amends guidance on the amortization period of premiums on certain purchased callable debt securities to shorten the amortization period of premiums on certain purchased callable debt securities to the earliest call date. The amendments are effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. The Corporation is currently evaluating the potential impact of ASU 2016-02 on its financial statements and disclosures.

### Adoption of New Accounting Policies

In the first quarter of 2017, the Corporation adopted ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting". ASU 2016-09 simplifies certain aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classifications of awards either as equity or liabilities, and classifications on the statement of cash flows. This ASU did not have a material impact on the Corporation's financial statements and disclosures.

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

This section discusses the consolidated financial condition and results of operations of Emclave Financial Corp and its wholly owned subsidiaries for the six months ended June 30, 2017, compared to the same period in 2016 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 31 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 \$44.7 million, or 6.5%, to \$736.9 million at June 30, 2017 from \$692.1 million at December 31, 2016. Asset growth was driven by increases in net loans receivable and cash and equivalents of \$30.3 million and \$17.1 million, respectively. Loan growth was the result of strong production in the Bank's retail and commercial channels, with residential mortgages and commercial mortgages increasing by \$16.7 million and \$12.9 million, respectively. Total liabilities increased \$42.2 million, or 6.6%, to \$680.2 million at June 30, 2017 from \$638.1 million at December 31, 2016, resulting primarily from a \$44.2 million, or 7.6%, increase in customer deposits. Deposit growth consisted of a \$38.7 million, or 8.4%, increase in interest bearing deposits and a \$5.5 million, or 4.5%, increase in noninterest-bearing deposits.

Stockholders' equity increased \$2.6 million, or 4.8%, to \$56.6 million at June 30, 2017 from \$54.1 million at December 31, 2016 primarily due to proceeds from the exercise of stock options of \$1.3 million and net income of \$2.0 million for the six month period, offset by common stock dividends paid of \$1.2 million. Book value per common share was \$25.74 at June 30, 2017, compared to \$25.12 at December 31, 2016.

At June 30, 2017, the Bank was considered "well-capitalized" with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.78%, 11.29%, 11.29% and 12.47%, respectively. The Bank was also considered "well-capitalized" at December 31, 2016 with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.84%, 11.49%, 11.49% and 12.69%, respectively.



## RESULTS OF OPERATIONS

### *Comparison of Results for the Three Months Ended June 30, 2017 and 2016*

**General.** Net income increased \$111,000, or 11.9%, to \$1.0 million for the three months ended June 30, 2017 from \$930,000 for the same period in 2016. This increase was the result of an increase in net interest income of \$505,000, respectively, partially offset by a \$74,000 decrease in noninterest income and increases in noninterest expense, the provision for loans losses and the provision for income taxes of \$213,000, \$80,000 and \$27,000, respectively.

**Net interest income.** Tax equivalent net interest income increased \$490,000, or 9.8%, to \$5.5 million for the three months ended June 30, 2017 from \$5.0 million for the three months ended June 30, 2016. This increase was attributed to an increase in tax equivalent interest income of \$540,000, partially offset by an increase in interest expense of \$50,000.

**Interest income.** Tax equivalent interest income increased \$540,000, or 9.0%, to \$6.6 million for the three months ended June 30, 2017 from \$6.0 million for the same period in 2016. This increase was attributed to increases in interest earned on loans and dividends on federal bank stocks of \$607,000 and \$9,000, respectively, partially offset by decreases in interest earned on securities and interest-earnings deposits with bank of \$71,000 and \$5,000, respectively.

Tax equivalent interest earned on loans receivable increased \$607,000, or 11.5%, to \$5.9 million for the three months ended June 30, 2017 compared to \$5.3 million for the same period in 2016. This increase resulted from a \$66.5 million, or 13.8% increase in average loans, accounting for an increase of \$717,000 in interest income. The increase in loans receivable was related to the acquisition of United American in April 2016 and strong loan growth achieved in 2016 and the first half of 2017. Partially offsetting this favorable volume variance, the average yield on loans decreased 11 basis points to 4.31% for the three months ended June 30, 2017, versus 4.42% for the same period in 2016. This unfavorable yield variance accounted for a \$110,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$71,000, or 10.8%, to \$585,000 for the three months ended June 30, 2017 compared to \$656,000 for the three months ended June 30, 2016. This decrease resulted from a \$12.5 million, or 11.2%, decrease in the average balance of securities, accounting for a \$74,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased one basis point to 2.37% for the three months ended June 30, 2017 versus 2.36% for the same period in 2016. This favorable yield variance accounted for a \$5,000 increase in interest income.

Interest earned on deposits with banks decreased \$5,000 to \$38,000 for the three months ended June 30, 2017 compared to \$43,000 for the three months ended June 30, 2016. This decrease resulted from a \$13.3 million, or 36.8%, decrease in the average balance of interest-earning deposits, accounting for a decrease of \$24,000 in interest income. Partially offsetting the unfavorable volume variance, the average yield on these accounts increased 32 basis points to 0.85% for the three months ended June 30, 2017, versus 0.53% for the same period in 2016, accounting for a \$19,000 increase in interest income.

Dividends on federal bank stocks increased \$9,000, or 17.3%, to \$61,000 for the three months ended June 30, 2017 from \$52,000 for the same period in 2016. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.0 million, or 27.4%, to \$4.8 million compared to \$3.8 million for the same period in 2016, accounting for a \$13,000 increase in interest income. Partially offsetting the favorable volume variance, the average yield on these assets decreased 45 basis points to 5.10% for the three months ended June 30, 2017, versus 5.55% for the same period in 2016, accounting for a \$4,000 decrease in interest income.

**Interest expense.** Interest expense increased \$50,000, or 4.9%, to \$1.1 million for the three months ended June 30, 2017 from \$1.0 million for the same period in 2016. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$28,000 and \$22,000, respectively.

Interest expense incurred on deposits increased \$28,000, or 3.9%, to \$749,000 for the three months ended June 30, 2017 compared to \$721,000 for the same period in 2016. The average balance of interest-bearing deposits increased \$33.3 million, or 7.4%, to \$481.4 million for the three months ended June 30, 2017, compared to \$448.1 million for the same period in 2016 causing a \$52,000 increase in interest expense. This increase was primarily due to the acquisition of United American in April 2016 and strong deposit growth during the first half of 2017. Partially offsetting the volume variance, the average cost of interest-bearing deposits decreased 3 basis points to 0.62% for the three months ended June 30, 2017, versus 0.65% for the same period in 2016, accounting for a \$24,000 reduction in interest expense.

Interest expense incurred on borrowed funds increased \$22,000, or 7.4%, to \$318,000 for the three months ended June 30, 2017, compared to \$296,000 for the same period in the prior year. The average balance of borrowed funds increased \$2.9 million, or 7.6%, to \$41.0 million for the three months ended June 30, 2017, compared to \$38.1 million for the same period in 2016 causing a \$15,000 increase in interest expense. Additionally, the average cost of long term borrowed funds increased 20 basis points to 3.06% for the six months ended June 30, 2017 compared to 2.86% for the same period in 2016 causing a \$17,000 increase in interest expense. These unfavorable variance were partially offset by the average cost of short term borrowed funds having decreased 88 basis points to 3.79% for the six months ended June 30, 2017 compared to 4.67% for the same period in 2016 causing a \$10,000 decrease in interest expense.

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

(Dollar amounts in thousands)

	Three months ended June 30,					
	2017			2016		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$ 523,363	\$ 5,610	4.30%	\$ 454,059	\$ 4,972	4.40%
Loans, tax exempt	23,454	272	4.65%	26,267	303	4.63%
<i>Total loans receivable</i>	<u>546,817</u>	<u>5,882</u>	4.31%	<u>480,326</u>	<u>5,275</u>	4.42%
Securities, taxable	73,694	392	2.13%	83,092	441	2.13%
Securities, tax exempt	25,347	193	3.05%	28,490	215	3.03%
<i>Total securities</i>	<u>99,041</u>	<u>585</u>	2.37%	<u>111,582</u>	<u>656</u>	2.36%
Interest-earning deposits with banks	18,035	38	0.85%	32,343	43	0.53%
Federal bank stocks	4,798	61	5.10%	3,767	52	5.55%
<i>Total interest-earning cash equivalents</i>	<u>22,833</u>	<u>99</u>	1.74%	<u>36,110</u>	<u>95</u>	1.06%
<b>Total interest-earning assets</b>	<b>668,691</b>	<b>6,566</b>	<b>3.94%</b>	<b>628,018</b>	<b>6,026</b>	<b>3.86%</b>
Cash and due from banks	2,679			2,514		
Other noninterest-earning assets	<u>45,805</u>			<u>42,778</u>		
Total Assets	<u>\$ 717,175</u>			<u>\$ 673,310</u>		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 316,823	\$ 200	0.25%	\$ 291,053	\$ 154	0.21%
Time deposits	164,530	549	1.34%	157,033	567	1.45%
<i>Total interest-bearing deposits</i>	<u>481,353</u>	<u>749</u>	0.62%	<u>448,086</u>	<u>721</u>	0.65%
Borrowed funds, short-term	3,037	29	3.79%	5,417	63	4.67%
Borrowed funds, long-term	37,950	289	3.06%	32,688	233	2.86%
<i>Total borrowed funds</i>	<u>40,987</u>	<u>318</u>	3.11%	<u>38,105</u>	<u>296</u>	3.12%
<b>Total interest-bearing liabilities</b>	<b>522,340</b>	<b>1,067</b>	<b>0.82%</b>	<b>486,191</b>	<b>1,017</b>	<b>0.84%</b>
Noninterest-bearing demand deposits	129,775	—	—	124,178	—	—
<b>Funding and cost of funds</b>	<b>652,115</b>	<b>1,067</b>	<b>0.66%</b>	<b>610,369</b>	<b>1,017</b>	<b>0.67%</b>
Other noninterest-bearing liabilities	<u>9,398</u>			<u>8,768</u>		
Total Liabilities	661,513			619,137		
Stockholders' Equity	<u>55,662</u>			<u>54,173</u>		
Total Liabilities and Stockholders' Equity	\$ 717,175			\$ 673,310		
<b>Net interest income</b>		<u>\$ 5,499</u>			<u>\$ 5,009</u>	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			<u>3.12%</u>			<u>3.02%</u>
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			<u>3.30%</u>			<u>3.21%</u>



**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)*

	<b>Three months ended June 30, 2017 versus 2016</b>		
	<b>Increase (Decrease) due to</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
<b>Interest income:</b>			
Loans	\$ 717	\$ (110)	\$ 607
Securities	(74)	3	(71)
Interest-earning deposits with banks	(24)	19	(5)
Federal bank stocks	13	(4)	9
	<u>632</u>	<u>(92)</u>	<u>540</u>
Total interest-earning assets			
<b>Interest expense:</b>			
Interest-bearing deposits	52	(24)	28
Borrowed funds, short-term	(24)	(10)	(34)
Borrowed funds, long-term	39	17	56
	<u>67</u>	<u>(17)</u>	<u>50</u>
Total interest-bearing liabilities			
<b>Net interest income</b>	<u>\$ 565</u>	<u>\$ (75)</u>	<u>\$ 490</u>

**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 June 30, 2017 and 2016 is as follows:

<i>(Dollar amounts in thousands)</i>	<b>As of or for the three months ended</b>	
	<b>June 30,</b>	
	<b>2017</b>	<b>2016</b>
Balance at the beginning of the period	\$ 5,688	\$ 5,352
Provision for (recovery of) loan losses	201	121
Charge-offs	(128)	(47)
Recoveries	6	5
Balance at the end of the period	<u>\$ 5,767</u>	<u>\$ 5,431</u>
Nonperforming loans	\$ 3,045	\$ 3,268
Nonperforming assets	3,251	3,415
Nonperforming loans to total loans	0.55%	0.65%
Nonperforming assets to total assets	0.44%	0.49%
Allowance for loan losses to total loans	1.05%	1.08%
Allowance for loan losses to nonperforming loans	189.39%	166.19%

Nonperforming loans decreased \$63,000, or 2.0%, to \$3.0 million at June 30, 2017 from \$3.1 million at March 31, 2017. Of the \$3.0 million in nonperforming loans, \$1.0 million were not past due at June 30, 2017.

As of June 30, 2017, the Corporation's classified and criticized assets amounted to \$9.7 million, or 1.3% of total assets, with \$8.0 million classified as substandard and \$1.7 million identified as special mention. This compares to classified and criticized assets of \$9.9 million, or 1.4% of total assets, with \$7.9 million classified as substandard and \$2.0 million identified as special mention at March 31, 2017. This decrease was related to the risk rating upgrade of one commercial loan relationship.

The provision for loan losses increased \$80,000, or 66.1%, to \$201,000 for the three months ended June 30, 2017 from \$121,000 for the same period in the prior year due primarily to general growth in the loan portfolio.

**Noninterest income.** Noninterest income decreased \$74,000, or 7.9%, to \$868,000 for the three months ended June 30, 2017, compared to \$942,000 for the same period in 2016. During the quarter ended June 30, 2017, the Corporation recorded a \$508,000 other-than-temporary impairment charge on a subordinated debt investment issued by First NBC Bank Holding Company. On April 28, 2017, the Louisiana Office of Financial Institutions closed First NBC Bank, the wholly owned banking subsidiary of First NBC Bank Holding Company, and named the FDIC as receiver for the bank. Partially offsetting this impairment charge, the Corporation realized securities gains of \$350,000 during the quarter ended June 30, 2017, compared to \$81,000 during the same period in 2016. Additionally, gains on the sale of loans totaled \$124,000 for the quarter ended June 30, 2017 and customer service fees increased \$49,000 as overdraft charges for the second quarter of 2017 outpaced the same quarter last year.

**Noninterest expense.** Noninterest expense increased \$213,000, or 4.8%, to \$4.7 million for the three months ended June 30, 2017 compared to \$4.5 million for the same period in 2016. This increase in noninterest expense can be attributed to increases in compensation and benefits, premises and equipment, professional fees, acquisition costs, federal deposit insurance and intangible asset amortization of \$170,000, \$34,000, \$26,000, \$14,000, \$13,000 and \$3,000, respectively, partially offset by a \$47,000 decrease in other noninterest expense.

Compensation and employee benefits expense increased \$170,000, or 7.8%, to \$2.3 million for the three months ended June 30, 2017 compared to \$2.2 million for the same period in the prior year. This increase was primarily the result of increases in salaries, incentive compensation, retirement benefits and insurance benefits of \$61,000, \$54,000, \$26,000 and \$25,000, respectively. The increases in compensation and employee benefits related expenses were due primarily to the addition of the branch office in the United American acquisition in April 2016 and the opening of the new Aspinwall branch office in August 2016.

Premises and equipment expense increased \$34,000, or 4.9%, to \$726,000 for the three months ended June 30, 2017 compared to \$692,000 for the same period in the prior year. This increase was primarily the result of the two new branch offices which added \$64,000 of expense for the quarter ended June 30, 2017, compared to \$46,000 for the quarter ended June 30, 2016.

Acquisition expense increased by \$14,000 for the three months ended June 30, 2017 compared to the same period in the prior year. Costs related to the pending acquisition of Northern Hancock Bank and Trust Co. (Northern Hancock) totaled \$106,000 for the three months ended June 30, 2017, while costs related to the acquisition of United American totaled \$92,000 for the three months ended June 30, 2016.

The Corporation recognized \$59,000 of core deposit intangible amortization expense during the second quarter of 2017 compared to \$56,000 for the same period in 2016. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the "Notes to Consolidated Financial Statements" beginning on page 6.

Other noninterest expense decreased \$47,000, or 4.0%, to \$1.1 million for the three months ended June 30, 2017 compared to \$1.0 million for the same period in the prior year. This decrease primarily related to a prepayment penalty of \$71,000 associated with the early retirement of an FHLB advance recognized during the quarter ended June 30, 2016.

**Provision for income taxes** . The provision for income taxes increased \$27,000, or 9.4%, to \$314,000 for the three months ended June 30, 2017 compared to \$287,000 for the same period in the prior year. This related to an increase in the Corporation's net income before income taxes, partially offset by a decrease in the Corporation's effective tax rate to 23.2% for the three months ended June 30, 2017 compared to 23.6% for the same period in 2016.

#### ***Comparison of Results for the Six Months Ended June 30, 2017 and 2016***

**General.** Net income increased \$265,000, or 15.3%, to \$2.0 million for the six months ended June 30, 2017 from \$1.7 million for the same period in 2016. This increase was the result of an increase in net interest income of \$1.1 million, partially offset by increases in the provision for loans losses and noninterest expense of \$61,000 and \$816,000, respectively.

**Net interest income.** Tax equivalent net interest income increased \$1.1 million, or 11.4%, to \$10.8 million for the six months ended June 30, 2017 from \$9.7 million for the six months ended June 30, 2016. This increase was attributed to an increase in tax equivalent interest income of \$1.3 million, partially offset by an increase in interest expense of \$235,000.

**Interest income.** Tax equivalent interest income increased \$1.3, or 11.6%, to \$12.9 million for the six months ended June 30, 2017 from \$11.5 million for the same period in 2016. This increase was attributed to increases in interest earned on loans and dividends on federal bank stocks of \$1.5 million and \$28,000, respectively, partially offset by decreases in interest earned on securities and interest-earnings deposits with bank of \$133,000 and \$9,000, respectively.

Tax equivalent interest earned on loans receivable increased \$1.5 million, or 14.5%, to \$11.5 million for the six months ended June 30, 2017 compared to \$10.1 million for the same period in 2016. This increase resulted from a \$81.6 million, or 17.8% increase in average loans, accounting for an increase of \$1.7 million in interest income. The increase in loans receivable was partially related to the acquisition of United American in April 2016. Partially offsetting this favorable volume variance, the average yield on loans decreased 11 basis points to 4.30% for the six months ended June 30, 2017, versus 4.41% for the same period in 2016. This unfavorable yield variance accounted for a \$289,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$133,000, or 10.2%, to \$1.2 million for the six months ended June 30, 2017 compared to \$1.1 million for the six months ended June 30, 2016. This decrease resulted from an \$12.0 million, or 10.8%, decrease in the average balance of securities, accounting for a \$142,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 3 basis points to 2.39% for the six months ended June 30, 2017 versus 2.36% for the same period in 2016. This favorable yield variance accounted for a \$79,000 increase in interest income.

Interest earned on deposits with banks decreased \$9,000 to \$53,000 for the six months ended June 30, 2017 compared to \$62,000 for the six months ended June 30, 2016. This decrease resulted from a \$10.0 million decrease in the average balance of interest-earning deposits, accounting for a decrease of \$32,000 in interest income. Partially offsetting the unfavorable volume variance, the average yield on these accounts increased 26 basis points to 0.79% for the six months ended June 30, 2017, versus 0.53% for the same period in 2016, accounting for a \$23,000 increase in interest income.

Dividends on federal bank stocks increased \$28,000, or 32.2%, to \$115,000 for the six months ended June 30, 2017 from \$87,000 for the same period in 2016. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.3 million, or 38.3%, to \$4.9 million compared to \$3.5 million for the same period in 2016, accounting for a \$32,000 increase in interest income. Partially offsetting the favorable volume variance, the average yield on these assets decreased 20 basis points to 4.77% for the six months ended June 30, 2017, versus 4.97% for the same period in 2016, accounting for a \$4,000 decrease in interest income.

**Interest expense.** Interest expense increased \$235,000, or 12.7%, to \$2.1 million for the six months ended June 30, 2017 from \$1.8 million for the same period in 2016. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$143,000 and \$92,000, respectively.

Interest expense incurred on deposits increased \$143,000, or 10.9%, to \$1.5 million for the six months ended June 30, 2017 compared to \$1.3 million for the same period in 2016. The average balance of interest-bearing deposits increased \$54.0 million, or 12.9%, to \$473.4 million for the six months ended June 30, 2017, compared to \$419.4 million for the same period in 2016 causing a \$166,000 increase in interest expense. This increase was primarily due to the acquisition of United American in April 2016. Partially offsetting the volume variance, the average cost of interest-bearing deposits decreased one basis point to 0.61% for the six month ended June 30, 2017, compared to 0.62% for the same period in 2016 causing a \$23,000 decrease in interest expense.

Interest expense incurred on borrowed funds increased \$92,000, or 17.0%, to \$632,000 for the six months ended June 30, 2017, compared to \$540,000 for the same period in the prior year. The average balance of borrowed funds increased \$5.5 million, or 14.6%, to \$42.7 million for the six months ended June 30, 2017, compared to \$37.3 million for the same period in 2016 causing a \$76,000 increase in interest expense. Additionally, the average cost of borrowed funds increased 7 basis points to 2.98% for the six months ended June 30, 2017 compared to 2.91% for the same period in 2016 causing a \$16,000 increase in interest expense.



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

(Dollar amounts in thousands)

	Six months ended June 30,					
	2017			2016		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$ 517,064	\$ 10,984	4.28%	\$ 432,717	\$ 9,452	4.39%
Loans, tax exempt	23,619	544	4.64%	26,399	619	4.72%
<i>Total loans receivable</i>	<u>540,683</u>	<u>11,528</u>	4.30%	<u>459,116</u>	<u>10,071</u>	4.41%
Securities, taxable	73,498	787	2.16%	82,887	874	2.12%
Securities, tax exempt	25,964	390	3.03%	28,623	436	3.06%
<i>Total securities</i>	<u>99,462</u>	<u>1,177</u>	2.39%	<u>111,510</u>	<u>1,310</u>	2.36%
Interest-earning deposits with banks	13,579	53	0.79%	23,577	62	0.53%
Federal bank stocks	4,863	115	4.77%	3,517	87	4.97%
<i>Total interest-earning cash equivalents</i>	<u>18,442</u>	<u>168</u>	1.84%	<u>27,094</u>	<u>149</u>	1.11%
<b>Total interest-earning assets</b>	<b>658,587</b>	<b>12,873</b>	<b>3.94%</b>	<b>597,720</b>	<b>11,530</b>	<b>3.88%</b>
Cash and due from banks	2,664			2,439		
Other noninterest-earning assets	<u>46,190</u>			<u>39,237</u>		
Total Assets	<u>\$ 707,441</u>			<u>\$ 639,396</u>		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 311,276	\$ 370	0.24%	\$ 280,454	\$ 285	0.20%
Time deposits	162,152	1,082	1.35%	138,954	1,024	1.48%
<i>Total interest-bearing deposits</i>	<u>473,428</u>	<u>1,452</u>	0.62%	<u>419,408</u>	<u>1,309</u>	0.63%
Borrowed funds, short-term	6,627	71	2.15%	3,448	65	3.77%
Borrowed funds, long-term	36,119	561	3.13%	33,846	475	2.82%
<i>Total borrowed funds</i>	<u>42,746</u>	<u>632</u>	2.98%	<u>37,294</u>	<u>540</u>	2.91%
<b>Total interest-bearing liabilities</b>	<b>516,174</b>	<b>2,084</b>	<b>0.81%</b>	<b>456,702</b>	<b>1,849</b>	<b>0.81%</b>
Noninterest-bearing demand deposits	126,859	—	—	120,201	—	—
<b>Funding and cost of funds</b>	<b>643,033</b>	<b>2,084</b>	<b>0.65%</b>	<b>576,903</b>	<b>1,849</b>	<b>0.64%</b>
Other noninterest-bearing liabilities	<u>9,354</u>			<u>8,631</u>		
Total Liabilities	652,387			585,534		
Stockholders' Equity	<u>55,054</u>			<u>53,862</u>		
Total Liabilities and Stockholders' Equity	\$ 707,441			\$ 639,396		
<b>Net interest income</b>		<u><b>\$ 10,789</b></u>			<u><b>\$ 9,681</b></u>	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			<u><b>3.13%</b></u>			<u><b>3.07%</b></u>
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			<u><b>3.30%</b></u>			<u><b>3.24%</b></u>



**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)

	<b>Six months ended June 30,</b>		
	<b>2017 versus 2016</b>		
	<b>Increase (Decrease) due to</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
<b>Interest income:</b>			
Loans	\$ 1,746	\$ (289)	\$ 1,457
Securities	(142)	9	(133)
Interest-earning deposits with banks	(32)	23	(9)
Federal bank stocks	32	(4)	28
Total interest-earning assets	<u>1,604</u>	<u>(261)</u>	<u>1,343</u>
<b>Interest expense:</b>			
Interest-bearing deposits	166	(23)	143
Borrowed funds, short-term	43	(37)	6
Borrowed funds, long-term	33	53	86
Total interest-bearing liabilities	<u>242</u>	<u>(7)</u>	<u>235</u>
<b>Net interest income</b>	<u>\$ 1,362</u>	<u>\$ (254)</u>	<u>\$ 1,108</u>

**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 six months ended June 30, 2017 and 2016 is as follows:

<i>(Dollar amounts in thousands)</i>	<b>As of or for the six months ended</b>			
	<b>June 30,</b>			
	<b>2017</b>		<b>2016</b>	
Balance at the beginning of the period	\$	5,545	\$	5,205
Provision for (recovery of) loan losses		363		302
Charge-offs		(174)		(88)
Recoveries		33		12
Balance at the end of the period	\$	5,767	\$	5,431
Nonperforming loans	\$	3,045	\$	3,268
Nonperforming assets		3,251		3,415
Nonperforming loans to total loans		0.55%		0.65%
Nonperforming assets to total assets		0.44%		0.49%
Allowance for loan losses to total loans		1.05%		1.08%
Allowance for loan losses to nonperforming loans		189.39%		166.19%

Nonperforming loans decreased \$278,000, or 8.4%, to \$3.0 million at June 30, 2017 from \$3.3 million at December 31, 2016. This decrease was primarily due to the payoff of two residential mortgage loans on nonaccrual status totaling \$391,000. Of the \$3.0 million in nonperforming loans, \$1.0 million were not past due at June 30, 2017.

As of June 30, 2017, the Corporation's classified and criticized assets amounted to \$9.7 million, or 1.4% of total assets, with \$8.0 million classified as substandard and \$1.7 million identified as special mention. This compares to classified and criticized assets of \$12.8 million, or 1.9% of total assets, with \$6.8 million classified as substandard and \$6.0 million identified as special mention at December 31, 2016. This decrease was primarily related to the risk rating upgrade of one commercial loan relationship.

The provision for loan losses decreased \$61,000, or 20.2%, to \$363,000 for the six months ended June 30, 2017 from \$302,000 for the same period in the prior year due primarily to general growth in the loan portfolio.

**Noninterest income.** Noninterest income was \$1.7 million for the six month periods ended June 30, 2017 and 2016. During the six months ended June 30, 2017, the Corporation recorded the aforementioned \$508,000 other-than-temporary impairment charge. Partially offsetting this impairment charge, the Corporation realized securities gains of \$350,000 during the six months ended June 30, 2017, compared to \$83,000 during the same period in 2016. Additionally, gains on the sale of loans totaled \$130,000 for the six months ended June 30, 2017 and customer service fees increased \$111,000 as overdraft charges for the first half of 2017 outpaced the same period last year.

**Noninterest expense.** Noninterest expense increased \$816,000, or 9.6%, to \$9.3 million for the six months ended June 30, 2017 compared to \$8.5 million for the same period in 2016. This increase in noninterest expense can be attributed to increases in compensation and benefits, premises and equipment, professional fees, federal deposit insurance, intangible asset amortization and other noninterest expense of \$445,000, \$106,000, \$44,000, \$28,000, \$14,000 and \$473,000, respectively, partially offset by a \$294,000 decrease in acquisition costs.

Compensation and employee benefits expense increased \$445,000, or 10.5%, to \$4.7 million for the six months ended June 30, 2017 compared to \$4.2 million for the same period in the prior year. This increase was primarily the result of increases in salaries, incentive compensation, retirement benefits, insurance benefits and payroll taxes of \$253,000, \$59,000, \$54,000, \$44,000 and \$29,000, respectively. The increases in compensation and employee benefits related expenses were due primarily to normal salary and wage increases, the addition of the branch office in the United American acquisition in April 2016 and the opening of the new Aspinwall branch office in August 2016.

Premises and equipment expense increased \$106,000, or 7.7%, to \$1.5 million for the six months ended June 30, 2017 compared to \$1.4 million for the same period in the prior year. This increase was primarily the result of the two new branch offices which added \$77,000 of expense for the six months ended June 30, 2017.

Other noninterest expense increased \$473,000, or 26.0%, to \$2.3 million for the six months ended June 30, 2017 compared to \$1.8 million for the same period in the prior year. Contributing to the increase were increases in travel and entertainment expenses, bad checks and other losses, overdraft privilege program administration fees, Pennsylvania shares tax, telecommunications expenses, collection expenses and operating costs of associated with the two new branch offices.

The Corporation recognized \$119,000 of core deposit intangible amortization expense during the first six months of 2017 compared to \$105,000 for the same period in 2016. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the "Notes to Consolidated Financial Statements" beginning on page 6.

Acquisition expense decreased by \$294,000 to \$107,000 for the six months ended June 30, 2017 compared to \$401,000 for the six months ended June 30, 2016. Costs for 2017 related to the pending acquisition of Northern Hancock Bank and Trust Co. (Northern Hancock), while costs for 2016 related to the acquisition of United American.

**Provision for income taxes** . The provision for income taxes increased \$3,000 to \$586,000 for the six months ended June 30, 2017 compared to \$583,000 for the same period in the prior year. This related to an increase in the Corporation's net income before income taxes, partially offset by a decrease in the Corporation's effective tax rate to 22.7% for the six months ended June 30, 2017 compared to 25.2% for the same period in 2016. The decrease in the Corporation's effective tax rate was due to certain nondeductible merger related expenses incurred in the first six months of 2016.

## **LIQUIDITY**

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB, Federal Reserve and other correspondent banks, and amortization and prepayments of outstanding loans and maturing securities. During the six months ended June 30, 2017, the Corporation used its sources of funds primarily to fund loan advances and repay short term borrowed funds. As of June 30, 2017, 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 \$66,000, net of collateral maintained by the Bank.

At June 30, 2017, time deposits amounted to \$167.3 million, or 26.6% of the Corporation's total consolidated deposits, including approximately \$48.0 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 and the Bank have alternative sources of funds. These sources include a line of credit for the Corporation with a correspondent bank, the Bank's line of credit and term borrowing capacity from the FHLB and the Federal Reserve's discount window and, to a more limited extent, through the sale of loans. At June 30, 2017, the Corporation had borrowed funds of \$41.5 million consisting of \$35.0 million of long-term FHLB advances, a \$4.0 million long-term advance with a correspondent bank and \$2.5 million outstanding on a line of credit with a correspondent bank. At June 30, 2017, the Corporation's borrowing capacity with the FHLB, net of funds borrowed and irrevocable standby letters of credit issue to secure certain deposit accounts, was \$198.6 million.

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

## **RECENT REGULATORY DEVELOPMENTS**

The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks were approved by the FRB and FDIC. Under the final rules, minimum requirements increased for both the quantity and quality of capital. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0% and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer comprised of common equity Tier 1 capital was also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625%

until reaching its final level of 2.5% on January 1, 2019. Eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, Total Capital and risk-weighted assets. The phase-in period for the final rules became effective on January 1, 2015 with full compliance with all of the final rules' requirements phased in over a multi-year schedule to be fully phased-in by January 1, 2019.

At June 30, 2017, the Bank exceeded all minimum capital requirements under these capital guidelines.

## **CRITICAL ACCOUNTING POLICIES**

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

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016. 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, 2016, 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 June 30, 2017, the Corporation's interest-earning assets maturing or repricing within one year totaled \$214.0 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$209.9 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$4.1 million. At June 30, 2017, 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, 2016.

### **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 June 30, 2017, 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**

<a href="#">Exhibit 31.1</a>	Rule 13a-14(a) Certification of Principal Executive Officer
<a href="#">Exhibit 31.2</a>	Rule 13a-14(a) Certification of Principal Financial Officer
<a href="#">Exhibit 32.1</a>	CEO Certification Pursuant to 18 U.S.C. Section 1350
<a href="#">Exhibit 32.2</a>	CFO Certification Pursuant to 18 U.S.C. Section 1350
<b>101.INS</b>	XBRL Instance Document
<b>101.SCH</b>	XBRL Taxonomy Extension Schema Document
<b>101.CAL</b>	XBRL Taxonomy Extension Calculation Linkbase Document
<b>101.DEF</b>	XBRL Taxonomy Extension Definitions Linkbase Document
<b>101.LAB</b>	XBRL Taxonomy Extension Label Linkbase Document
<b>101.PRE</b>	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: August 14, 2017

By: /s/ William C. Marsh

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William C. Marsh

Chairman of the Board,

President and Chief Executive Officer

Date: August 14, 2017

By: /s/ Amanda L. Engles

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Amanda L. Engles

Chief Financial Officer

Treasurer

**Exhibit 31.1**

**Certification of the Principal Executive Officer**  
(Pursuant to Rule 13a-14(a))

I, William C. Marsh, Chairman of the Board, President and Chief Executive Officer, certify that:

1. I have reviewed this Form 10-Q of Emclaire Financial Corp;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the consolidated financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal controls over financial reporting or caused such internal controls over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2017

By:           /s/ William C. Marsh

William C. Marsh  
Chairman of the Board,  
President and Chief Executive Officer

**Exhibit 31.2**

**Certification of the Principal Financial Officer**  
(Pursuant to Rule 13a-14(a))

I, Amanda L. Engles, Chief Financial Officer and Treasurer, certify that:

1. I have reviewed this Form 10-Q of Emclaire Financial Corp;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the consolidated financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal controls over financial reporting or caused such internal controls over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2017

By:           /s/ Amanda L. Engles

Amanda L. Engles  
Chief Financial Officer  
Treasurer

**Exhibit 32.1**

**CEO CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350**

In connection with the Quarterly Report of Emclaire Financial Corp (the Corporation) on Form 10-Q for the period ending June 30, 2017 as filed with the Securities and Exchange Commission on the date hereof (the Report), I, William C. Marsh, Chief Executive Officer of the Corporation, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the consolidated financial condition and result of operations of the Corporation.

/s/ William C. Marsh

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William C. Marsh  
Chairman of the Board,  
President and Chief Executive Officer

August 14, 2017

Note: A signed original of this written statement has been provided to Emclaire Financial Corp and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

**Exhibit 32.2**

**CFO CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350**

In connection with the Quarterly Report of Emclaire Financial Corp (the Corporation) on Form 10-Q for the period ending June 30, 2017 as filed with the Securities and Exchange Commission on the date hereof (the Report), I, Amanda L. Engles, Chief Financial Officer of the Corporation, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the consolidated financial condition and result of operations of the Corporation.

/s/ Amanda L. Engles

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Amanda L. Engles  
Chief Financial Officer

August 14, 2017

Note: A signed original of this written statement has been provided to Emclaire Financial Corp and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.