

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
August 10, 2018

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, 2018

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

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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 2,271,139 at August 9, 2018.

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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, 2018 and December 31, 2017

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

	June 30, 2018	December 31, 2017
Assets		
Cash and due from banks	\$2,648	\$ 3,072
Interest earning deposits with banks	27,928	11,302
Cash and cash equivalents	30,576	14,374
Securities - available for sale	99,886	99,350
Securities - equity investments	474	1,817
Loans held for sale	—	504
Loans receivable, net of allowance for loan losses of \$6,118 and \$6,127	587,258	577,234
Federal bank stocks, at cost	4,403	4,662
Bank-owned life insurance	11,890	11,724
Accrued interest receivable	2,250	2,217
Premises and equipment, net	17,768	18,010
Goodwill	10,288	10,288
Core deposit intangible, net	345	481
Prepaid expenses and other assets	10,181	9,423
<b>Total Assets</b>	<b>\$775,319</b>	<b>\$ 750,084</b>
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	\$129,301	\$ 126,263
Interest bearing	556,250	528,380
Total deposits	685,551	654,643
Short-term borrowed funds	2,050	2,500
Long-term borrowed funds	18,000	23,500
Accrued interest payable	410	413
Accrued expenses and other liabilities	9,815	9,937
<b>Total Liabilities</b>	<b>715,826</b>	<b>690,993</b>
Commitments and Contingent Liabilities	—	—
Stockholders' Equity:		
	2,966	2,966

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Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,373,156 and 2,373,156 shares issued; 2,271,139 and 2,271,139 shares outstanding, respectively		
Additional paid-in capital	31,181	31,031
Treasury stock, at cost; 102,017 shares	(2,114 )	(2,114 )
Retained earnings	34,416	32,726
Accumulated other comprehensive loss	(6,956 )	(5,518 )
Total Stockholders' Equity	59,493	59,091
Total Liabilities and Stockholders' Equity	\$775,319	\$ 750,084

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Net Income (Unaudited)

For the three and six months ended June 30, 2018 and 2017

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

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Interest and dividend income:				
Loans receivable, including fees	\$6,678	\$ 5,801	\$13,015	\$11,367
Securities:				
Taxable	439	392	847	787
Exempt from federal income tax	141	140	293	283
Federal bank stocks	93	61	157	115
Interest earning deposits with banks	83	38	117	53
Total interest and dividend income	7,434	6,432	14,429	12,605
Interest expense:				
Deposits	1,102	749	2,093	1,452
Borrowed funds	141	318	299	632
Total interest expense	1,243	1,067	2,392	2,084
Net interest income	6,191	5,365	12,037	10,521
Provision for loan losses	300	201	680	363
Net interest income after provision for loan losses	5,891	5,164	11,357	10,158
Noninterest income:				
Fees and service charges	463	435	900	842
Net realized gain (loss) on sales of securities	(2 )	350	(31 )	350
Net gain on sales of loans	2	124	24	130
Other-than-temporary impairment loss	—	(508 )	—	(508 )
Earnings on bank-owned life insurance	103	101	206	202
Other	483	366	848	707
Total noninterest income	1,049	868	1,947	1,723
Noninterest expense:				
Compensation and employee benefits	2,521	2,347	4,974	4,670
Premises and equipment	758	726	1,528	1,484
Intangible asset amortization	68	59	136	119
Professional fees	254	216	470	417
Federal deposit insurance	151	102	288	210
Acquisition costs	358	106	358	107
Other	1,135	1,121	2,227	2,291
Total noninterest expense	5,245	4,677	9,981	9,298
Income before provision for income taxes	1,695	1,355	3,323	2,583

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Provision for income taxes	282	314	548	586
Net income	\$1,413	\$ 1,041	\$2,775	\$1,997
Basic earnings per common share	\$0.62	\$ 0.48	\$1.22	\$0.93
Diluted earnings per common share	0.62	0.48	1.21	\$0.92
Average common shares outstanding - basic	2,271,139	2,164,747	2,271,139	2,158,587
Average common shares outstanding - diluted	2,288,229	2,182,761	2,286,802	2,175,523

See accompanying notes to consolidated financial statements.

Emclaire Financial Corp  
Consolidated Statements of Comprehensive Income (Unaudited)  
For the three and six months ended June 30, 2018 and 2017  
(Dollar amounts in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Net income	\$1,413	\$1,041	\$2,775	\$1,997
Other comprehensive income				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gain (loss) arising during the period	(301 )	15	(1,615 )	406
Reclassification adjustment for (gains) losses included in net income	2	(350 )	31	(350 )
Reclassification adjustment for other-than-temporary impairment losses included in net income	—	508	—	508
Tax effect	(299 )	173	(1,584 )	564
	63	(59 )	333	(192 )
Net of tax	(236 )	114	(1,251 )	372
Comprehensive income	\$1,177	\$1,155	\$1,524	\$2,369

See accompanying notes to consolidated financial statements.



Emclaire Financial Corp  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
For the six months ended June 30, 2018 and 2017  
(Dollar amounts in thousands)

	For the six months ended June 30,	
	2018	2017
Cash flows from operating activities		
Net income	\$2,775	\$1,997
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	574	578
Provision for loan losses	680	363
Amortization of premiums, net	223	174
Amortization of intangible assets and mortgage servicing rights	162	143
Impairment loss on security recognized in earnings	—	508
Realized (gains) losses on sales of securities, net	31	(350 )
Net gains on sales of loans	(24 )	(130 )
Net loss on foreclosed real estate	44	—
Gain on sale of premises and equipment	(25 )	—
Loans originated for sale	(2,038 )	(3,265 )
Proceeds from the sale of loans originated for sale	2,566	3,371
Write-down of foreclosed real estate	11	—
Stock compensation expense	150	110
Increase in bank-owned life insurance, net	(166 )	(165 )
Increase in accrued interest receivable	(33 )	(12 )
(Increase) decrease in prepaid expenses and other assets	(159 )	332
Increase (decrease) in accrued interest payable	(3 )	120
Increase (decrease) in accrued expenses and other liabilities	(122 )	302
Net cash provided by operating activities	4,646	4,076
Cash flows from investing activities		
Loan originations and principal collections, net	(11,427 )	(32,600 )
Proceeds from sales of loans held for sale previously classified as portfolio loans	—	1,817
Securities:		
Sales	6,795	18,195
Maturities, repayments and calls	4,810	5,850
Purchases	(12,555 )	(21,939 )
Redemption of federal bank stocks	259	(1 )
Proceeds from the sale of bank premises and equipment	155	—
Proceeds from the sale of foreclosed real estate	165	124
Purchases of premises and equipment	(332 )	(204 )
Net cash used in investing activities	(12,130 )	(28,758 )
Cash flows from financing activities		
Net increase in deposits	30,908	44,234
Repayments on long-term debt	(5,500 )	(500 )
Proceeds from other long-term debt	—	5,000

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Net change in short-term borrowings	(450 )	(7,000 )
Proceeds from exercise of stock options	—	1,263
Dividends paid	(1,272 )	(1,168 )
Net cash provided by financing activities	23,686	41,829
Increase in cash and cash equivalents	16,202	17,147
Cash and cash equivalents at beginning of period	14,374	17,568
Cash and cash equivalents at end of period	\$30,576	\$34,715
Supplemental information:		
Interest paid	\$2,395	\$1,964
Income taxes paid	420	575
Supplemental noncash disclosure:		
Transfers from loans to foreclosed real estate	526	39
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 six months ended June 30, 2018 and 2017

(Dollar amounts in thousands, except per share data)

	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at January 1, 2017	\$ 2,818	\$ 27,900	\$(2,114)	\$29,960	\$ (4,491 )	\$ 54,073
Net income				1,997		1,997
Other comprehensive income					372	372
Stock compensation expense		110				110
Exercise of stock options (48,586 shares), including tax benefit	—	1,263				1,263
Cash dividends declared on common stock (\$0.54 per share)				(1,168 )		(1,168 )
Balance at June 30, 2017	\$ 2,818	\$ 29,273	\$(2,114)	\$30,789	\$ (4,119 )	\$ 56,647
Balance at January 1, 2018, as previously presented	\$ 2,966	\$ 31,031	\$(2,114)	\$32,726	\$ (5,518 )	\$ 59,091
Cumulative effect of change in accounting principle for marketable equity securities, net of tax				187	(187 )	—
Balance at January 1, 2018, as adjusted	2,966	31,031	(2,114 )	32,913	(5,705 )	59,091
Net income				2,775		2,775
Other comprehensive loss					(1,251 )	(1,251 )
Stock compensation expense		150				150
Cash dividends declared on common stock (\$0.56 per share)				(1,272 )		(1,272 )
Balance at June 30, 2018	\$ 2,966	\$ 31,181	\$(2,114)	\$34,416	\$ (6,956 )	\$ 59,493

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 and northern West Virginia. 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, 2017, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2017 filed with the SEC.

The balance sheet at December 31, 2017 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 25, 2018, the Corporation and Community First Bancorp (Community First) announced that they have entered into an Agreement and Plan of Merger providing for the acquisition of Community First by the Corporation. Community First is the holding company for Community First Bank, a Pennsylvania bank headquartered in Reynoldsville, Pennsylvania and operates two offices located in Clarion County, Pennsylvania and two offices located in Jefferson County, Pennsylvania.

Under the terms of the merger agreement, Community First will merge into the Corporation and shareholders of Community First will receive 1.2008 shares of the Corporation's common stock and \$6.95 in cash for each share of common stock of Community First or approximately \$16.3 million in common stock and \$2.6 million in cash in the aggregate. The merger is expected to be completed in the fourth quarter of 2018, subject to the satisfaction of customary closing conditions, including regulatory approval and the approval of the shareholders of Community First.



## 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:

(Dollar amounts in thousands, except for per share amounts)	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Earnings per common share - basic				
Net income	\$1,413	\$ 1,041	\$2,775	\$ 1,997
Average common shares outstanding	2,271,133	2,164,747	2,271,133	2,158,587
Basic earnings per common share	\$0.62	\$ 0.48	\$ 1.22	\$ 0.93
Earnings per common share - diluted				
Net income	\$1,413	\$ 1,041	\$2,775	\$ 1,997
Average common shares outstanding	2,271,133	2,164,747	2,271,133	2,158,587
Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options	17,090	18,014	15,663	16,936
Average shares and dilutive potential common shares	2,288,223	2,182,761	2,286,802	2,175,523
Diluted earnings per common share	\$0.62	\$ 0.48	\$ 1.21	\$ 0.92

## 4. Securities

## Equity Securities

The Corporation held equity securities with fair values of \$474,000 and \$1.8 million at June 30, 2018 and December 31, 2017, respectively. Beginning January 1, 2018, with the adoption of ASU 2016-01, changes in the fair value of these securities are included in other income on the consolidated statements of net income as opposed to accumulated other comprehensive loss on the consolidated balance sheets. During the three and six months ended June 30, 2018, the Corporation recognized a gain of \$67,000 and \$62,000, respectively, on the equity securities held at June 30, 2018. During the three and six months ended June 30, 2018, the Corporation sold \$266,000 and \$1.2 million of equity securities, respectively, with a realized net loss of \$2,000 and \$25,000, respectively.

## Debt Securities - Available for Sale

The following table summarizes the Corporation's debt securities as of June 30, 2018 and December 31, 2017:

(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2018:				
U.S. Treasury and federal agency	\$4,536	\$ —	\$ (125 )	\$4,411
U.S. government sponsored entities and agencies	21,007	20	(437 )	20,590
U.S. agency mortgage-backed securities: residential	23,236	—	(692 )	22,544
U.S. agency collateralized mortgage obligations: residential	21,168	32	(946 )	20,254
State and political subdivisions	25,112	12	(464 )	24,660
Corporate debt securities	7,507	6	(86 )	7,427
	\$ 102,566	\$ 70	\$ (2,750 )	\$99,886
December 31, 2017:				
U.S. Treasury and federal agency	4,541	—	(69 )	4,472
U.S. government sponsored entities and agencies	14,136	2	(212 )	13,926
U.S. agency mortgage-backed securities: residential	20,904	7	(153 )	20,758
U.S. agency collateralized mortgage obligations: residential	22,607	25	(708 )	21,924
State and political subdivisions	29,249	87	(96 )	29,240
Corporate debt securities	9,009	38	(17 )	9,030
	\$ 100,446	\$ 159	\$ (1,255 )	\$99,350

The following table summarizes scheduled maturities of the Corporation's debt securities as of June 30, 2018. 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	\$3,120	\$3,108
Due after one year through five years	34,277	33,640
Due after five through ten years	18,018	17,672
Due after ten years	2,747	2,668

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Mortgage-backed securities: residential	23,236	22,544
Collateralized mortgage obligations: residential	21,168	20,254
	\$102,566	\$99,886

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## 4. Securities (continued)

Information pertaining to debt securities with gross unrealized losses at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

(Dollar amounts in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Description of Securities						
June 30, 2018:						
U.S. Treasury and federal agency	\$—	\$—	\$4,411	\$(125)	\$4,411	\$(125)
U.S. government sponsored entities and agencies	5,838	(154)	8,840	(283)	14,678	(437)
U.S. agency mortgage-backed securities: residential	16,542	(455)	6,002	(237)	22,544	(692)
U.S. agency collateralized mortgage obligations: residential	1,700	(6)	16,724	(940)	18,424	(946)
State and political subdivisions	16,528	(367)	3,364	(97)	19,892	(464)
Corporate debt securities	2,935	(69)	486	(17)	3,421	(86)
	\$43,543	\$(1,051)	\$39,827	\$(1,699)	\$83,370	\$(2,750)
December 31, 2017:						
U.S. Treasury and federal agency	\$—	\$—	\$4,472	\$(69)	\$4,472	\$(69)
U.S. government sponsored entities and agencies	3,447	(42)	8,975	(170)	12,422	(212)
U.S. agency mortgage-backed securities: residential	9,659	(48)	6,581	(105)	16,240	(153)
U.S. agency collateralized mortgage obligations: residential	954	(16)	19,147	(692)	20,101	(708)
State and political subdivisions	10,510	(60)	3,487	(36)	13,997	(96)
Corporate debt securities	2,992	(16)	999	(1)	3,991	(17)
	\$27,562	\$(182)	\$43,661	\$(1,073)	\$71,223	\$(1,255)

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

(Dollar amounts in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Proceeds	\$264	\$18,195	\$6,795	\$18,195
Gains (losses)	(2)	350	(31)	350
Tax (benefit) provision related to gains	—	119	(6)	119

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.

## 4. Securities (continued)

There were 120 debt securities in an unrealized loss position as of June 30, 2018, of which 53 were in an unrealized loss position for more than 12 months. Of these 53 securities, 24 were government-backed collateralized mortgage obligations, nine were state and political subdivision securities, eight were U.S. government sponsored entity and agency securities, six were mortgage-backed securities, five were U.S. Treasury securities and one was a corporate security. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider these debt securities with unrealized losses as of June 30, 2018 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:

(Dollar amounts in thousands)	June 30, 2018	December 31, 2017
Mortgage loans on real estate:		
Residential first mortgages	\$230,504	\$ 221,823
Home equity loans and lines of credit	100,454	99,940
Commercial real estate	198,602	193,068
	529,560	514,831
Other loans:		
Commercial business	54,693	58,941
Consumer	9,123	9,589
	63,816	68,530
Total loans, gross	593,376	583,361
Less allowance for loan losses	6,118	6,127
Total loans, net	\$587,258	\$ 577,234

Included in total loans above are net deferred costs of \$1.8 million and \$1.5 million at June 30, 2018 and December 31, 2017, 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, 2018, there was no allowance for loan losses allocated to loans acquired in the April 2016 acquisition of United American Savings Bank or the September 2017 acquisition of Northern Hancock Bank and Trust Co.

## 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:

(Dollar amounts in thousands)	Residential Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
Three months ended June 30, 2018:						
Allowance for loan losses:						
Beginning Balance	\$ 1,919	\$ 651	\$ 2,751	\$ 560	\$ 54	\$ 5,935
Charge-offs	—	(63 )	(33 )	—	(51 )	(147 )
Recoveries	—	10	16	1	3	30
Provision	114	52	148	(62 )	48	300
Ending Balance	\$ 2,033	\$ 650	\$ 2,882	\$ 499	\$ 54	\$ 6,118
Six months ended June 30, 2018:						
Allowance for loan losses:						
Beginning Balance	\$ 2,090	\$ 646	\$ 2,753	\$ 585	\$ 53	\$ 6,127
Charge-offs	(61 )	(83 )	(418 )	—	(170 )	(732 )
Recoveries	3	11	18	2	9	43
Provision	1	76	529	(88 )	162	680
Ending Balance	\$ 2,033	\$ 650	\$ 2,882	\$ 499	\$ 54	\$ 6,118
At June 30, 2018:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	\$ 7	\$ —	\$ —	\$ —	\$ —	\$ 7
Acquired loans collectively evaluated for impairment	—	—	—	—	—	—
Originated loans collectively evaluated for impairment	2,026	650	2,882	499	54	6,111
Total	\$ 2,033	\$ 650	\$ 2,882	\$ 499	\$ 54	\$ 6,118
Total loans:						
Individually evaluated for impairment	\$ 408	\$ 7	\$ 43	\$ 39	\$ —	\$ 497
Acquired loans collectively evaluated for impairment	18,501	10,203	24,247	2,173	1,307	56,431
Originated loans collectively evaluated for impairment	211,595	90,244	174,312	52,481	7,816	536,448
Total	\$ 230,504	\$ 100,454	\$ 198,602	\$ 54,693	\$ 9,123	\$ 593,376
At December 31, 2017:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	\$ 7	\$ —	\$ —	\$ —	\$ —	\$ 7

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Acquired loans collectively evaluated for impairment	—	—	—	—	—	—
Originated loans collectively evaluated for impairment	2,083	646	2,753	585	53	6,120
Total	\$2,090	\$646	\$2,753	\$585	\$53	\$6,127
Total loans:						
Individually evaluated for impairment	\$425	\$8	\$914	\$569	\$—	\$1,916
Acquired loans collectively evaluated for impairment	20,300	10,873	27,404	1,451	2,893	62,921
Originated loans collectively evaluated for impairment	201,098	89,059	164,750	56,921	6,696	518,524
Total	\$221,823	\$99,940	\$193,068	\$58,941	\$9,589	\$583,361
Three months ended June 30, 2017:						
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	\$1,994	\$639	\$2,460	\$621	\$53	\$5,767
Six months ended June 30, 2017:						
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	\$1,994	\$639	\$2,460	\$621	\$53	\$5,767

## 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, 2018:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the three months ended		
	As of June 30, 2018			June 30, 2018		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment in Period	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$74	\$ 74	\$ 7	\$75	\$ 1	\$ 1
Home equity and lines of credit	7	7	—	8	—	—
Commercial real estate	—	—	—	—	—	—
Commercial business	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$81</b>	<b>\$ 81</b>	<b>\$ 7</b>	<b>\$83</b>	<b>\$ 1</b>	<b>\$ 1</b>
				For the six months ended		
				June 30, 2018		
				Average Recorded Investment in Period	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages				\$75	\$ 2	\$ 2
Home equity and lines of credit				7	—	—
Commercial real estate				—	—	—
Commercial business				—	—	—
Consumer				—	—	—
<b>Total</b>				<b>\$82</b>	<b>\$ 2</b>	<b>\$ 2</b>
	Impaired Loans with No Specific Allowance			For the three months ended June 30,		
	As of June 30, 2018			2018		
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages	\$446	\$ 334	\$339	\$ 2	\$ 2	
Home equity and lines of credit	—	—	—	—	—	
Commercial real estate	43	43	190	73	73	
Commercial business	39	39	297	41	41	
Consumer	—	—	—	—	—	
<b>Total</b>	<b>\$528</b>	<b>\$ 416</b>	<b>\$826</b>	<b>\$ 116</b>	<b>\$ 116</b>	

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For the six months ended June 30,  
2018

	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$343	\$ 2	\$ 2
Home equity and lines of credit	—	—	—
Commercial real estate	431	73	73
Commercial business	387	42	42
Consumer	—	—	—
Total	\$1,161	\$ 117	\$ 117



## 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, 2017:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance					
	As of December 31, 2017			For the year ended December 31, 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	\$75	\$ 75	\$ 7	\$88	\$ 3	\$ 3
Home equity and lines of credit	8	8	—	2	—	—
Commercial real estate	—	—	—	111	—	—
Commercial business	—	—	—	118	—	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$83</b>	<b>\$ 83</b>	<b>\$ 7</b>	<b>\$319</b>	<b>\$ 3</b>	<b>\$ 3</b>
	Impaired Loans with No Specific Allowance					
	As of December 31, 2017			For the year ended December 31, 2017		
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period	
Residential first mortgages	\$461	\$ 350	\$289	\$ 8	\$ 8	
Home equity and lines of credit	—	—	—	—	—	
Commercial real estate	1,089	914	855	3	3	
Commercial business	569	569	498	3	3	
Consumer	—	—	—	—	—	
<b>Total</b>	<b>\$2,119</b>	<b>\$ 1,833</b>	<b>\$1,642</b>	<b>\$ 14</b>	<b>\$ 14</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, 2017:

(Dollar amounts in thousands)

	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>

	Impaired Loans with Specific Allowance					
	As of June 30, 2017			For the six 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				\$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>	

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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	—	—	—
Total	\$1,499	\$ 6	\$ 6

## 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, 2018 and December 31, 2017, the Corporation had \$415,000 and \$433,000, respectively, of loans classified as TDRs, which are included in impaired loans above. The Corporation had allocated \$7,000 and \$7,000 of specific allowance for these loans at June 30, 2018 and December 31, 2017, respectively.

During the three and six month periods ended June 30, 2018, the Corporation did not modify any loans as TDRs. During the three and six month periods 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 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, 2018 and 2017, 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.

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.

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

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, 2018 and December 31, 2017:

(Dollar amounts in thousands)

	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
June 30, 2018:						
Residential first mortgages	\$229,401	\$—	\$—	\$ 1,103	\$	—\$230,504
Home equity and lines of credit	99,474	—	—	980	—	100,454
Commercial real estate	—	187,762	3,831	7,009	—	198,602
Commercial business	—	53,355	234	1,104	—	54,693
Consumer	9,037	—	—	86	—	9,123
Total	\$337,912	\$241,117	\$ 4,065	\$ 10,282	\$	—\$593,376
December 31, 2017:						
Residential first mortgages	\$220,730	\$—	\$—	\$ 1,093	\$	—\$221,823
Home equity and lines of credit	98,946	—	—	994	—	99,940
Commercial real estate	—	182,460	2,744	7,864	—	193,068
Commercial business	—	56,960	477	1,504	—	58,941
Consumer	9,443	—	—	146	—	9,589
Total	\$329,119	\$239,420	\$ 3,221	\$ 11,601	\$	—\$583,361

## 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, 2018 and December 31, 2017:

(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	
June 30, 2018:						
Residential first mortgages	\$227,774	\$ 1,264	\$ 440	\$ 59	\$ 967	\$230,504
Home equity and lines of credit	98,592	753	244	323	542	100,454
Commercial real estate	196,655	1,111	343	184	309	198,602
Commercial business	54,654	—	—	—	39	54,693
Consumer	8,660	354	46	—	63	9,123
<b>Total loans</b>	<b>\$586,335</b>	<b>\$ 3,482</b>	<b>\$ 1,073</b>	<b>\$ 566</b>	<b>\$ 1,920</b>	<b>\$593,376</b>
December 31, 2017:						
Residential first mortgages	\$218,515	\$ 1,936	\$ 357	\$ 159	\$ 856	\$221,823
Home equity and lines of credit	98,112	598	370	334	526	99,940
Commercial real estate	190,451	1,026	430	197	964	193,068
Commercial business	58,058	74	225	—	584	58,941
Consumer	9,162	273	81	—	73	9,589
<b>Total loans</b>	<b>\$574,298</b>	<b>\$ 3,907</b>	<b>\$ 1,463</b>	<b>\$ 690</b>	<b>\$ 3,003</b>	<b>\$583,361</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, 2018 and December 31, 2017:

(Dollar amounts in thousands)

	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total
June 30, 2018:					
Residential first mortgages	\$353	\$ —	-\$ 74	\$540	\$967
Home equity and lines of credit	7	—	9	526	542
Commercial real estate	205	—	—	104	309
Commercial business	39	—	—	—	39
Consumer	—	—	—	63	63
<b>Total loans</b>	<b>\$604</b>	<b>\$ —</b>	<b>-\$ 83</b>	<b>\$ 1,233</b>	<b>\$ 1,920</b>
December 31, 2017:					
Residential first mortgages	366	—	75	415	856
Home equity and lines of credit	8	—	—	518	526
Commercial real estate	341	—	—	623	964
Commercial business	569	—	—	15	584
Consumer	—	—	—	73	73
<b>Total loans</b>	<b>\$ 1,284</b>	<b>\$ —</b>	<b>-\$ 75</b>	<b>\$ 1,644</b>	<b>\$ 3,003</b>

## 6. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$10,288	\$ —	\$10,288	\$ —
Core deposit intangibles	4,426	4,081	4,426	3,945
<b>Total</b>	<b>\$14,714</b>	<b>\$ 4,081</b>	<b>\$14,714</b>	<b>\$ 3,945</b>

Goodwill resulted from four acquisitions. 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 2017 or in the first six months of 2018.



The core deposit intangible asset, resulting from three 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, 2018 the Corporation recorded intangible amortization expense totaling \$68,000 and \$136,000 , respectively, compared to \$59,000 and \$119,000 , respectively for the same periods in 2017.

## 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, 2018, 52,533 shares of restricted stock and 88,433 stock options remain available for issuance under the plan.

Incentive stock options, non-incentive or compensatory stock options and share awards may be granted under the Plan. 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.

At June 30, 2018 there are no options that were granted or outstanding under the Plan.

A summary of the status of the Corporation's nonvested restricted stock awards as of June 30, 2018, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2018	33,400	\$ 27.70
Granted	—	—
Vested	—	—
Forfeited	—	—
Nonvested as of June 30, 2018	33,400	\$ 27.70

For the three and six month periods ended June 30, 2018, the Corporation recognized stock compensation expense of \$75,000 and \$150,000, respectively, compared to \$55,000 and \$110,000, respectively, for the same period in 2017. As of June 30, 2018, there was \$515,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next three 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.

## 8. Fair Value (continued)

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:

Securities (debt-available for sale, equities) – 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 certain 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 corporate debt and equity securities held by the Corporation. The Level 3 corporate debt securities consist of certain subordinated notes which are priced at par because management has determined that the par value approximates the fair value of these instruments. 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.

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, 2018 and December 31, 2017, the Corporation did not have any impaired loans carried at fair value measured using the fair value of collateral. There was no additional provision for loan losses recorded for impaired loans during the three and six month periods ended June 30, 2018 and 2017.

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, 2018, OREO measured at fair value less costs to sell had a net carrying amount of \$157,000, which consisted of the outstanding balance of \$168,000 less write-downs of \$11,000. As of December 31, 2017, the Corporation did not have any OREO measured at fair value.

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.

## 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:

(Dollar amounts in thousands)		(Level 1)	(Level 2)	(Level 3)
Description	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
June 30, 2018:				
Securities available for sale				
U.S. Treasury and federal agency	\$4,411	\$ 4,411	\$ —	\$ —
U.S. government sponsored entities and agencies	20,590	—	20,590	—
U.S. agency mortgage-backed securities: residential	22,544	—	22,544	—
U.S. agency collateralized mortgage obligations: residential	20,254	—	20,254	—
State and political subdivision	24,660	—	24,660	—
Corporate debt securities	7,427	—	3,927	3,500
	\$99,886	\$ 4,411	\$ 91,975	\$ 3,500
Equity securities	\$474	\$ 474	\$ —	\$ —
December 31, 2017:				
Securities available for sale				
U.S. Treasury and federal agency	4,472	4,472	—	—
U.S. government sponsored entities and agencies	13,926	—	13,926	—
U.S. agency mortgage-backed securities: residential	20,758	—	20,758	—
U.S. agency collateralized mortgage obligations: residential	21,924	—	21,924	—
State and political subdivisions	29,240	—	29,240	—
Corporate debt securities	9,030	—	1,032	7,998
	\$99,350	\$ 4,472	\$ 86,880	\$ 7,998
Equity securities	\$1,817	\$ 1,683	\$ —	\$ 134



## 8. Fair Value (continued)

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and six month period ended June 30, 2018 the Corporation reclassified a restricted bank stock from the equity security portfolio to other assets and certain corporate securities from Level 3 to Level 2. Also during the three and six month periods, \$25,000 in Level 3 equity securities were sold from the portfolio. For the same periods in 2017, 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, 2018 and 2017:

(Dollar amounts in thousands)	Three months		Six months	
	ended June 30,		ended June 30,	
	2018	2017	2018	2017
Balance at the beginning of the period	\$3,525	\$136	\$8,132	\$136
Total gains or losses (realized/unrealized):				
Included in earnings	—	—	1	—
Included in other comprehensive income	—	(1 )	—	(1 )
Acquired	—	—	—	—
Sold out of Level 3	(25 )	—	(25 )	—
Transfers in and/or out of Level 3	—	—	(4,608 )	—
Balance at the end of the period	\$3,500	\$135	\$3,500	\$135

The Corporation had \$157,000 in OREO assets measured at fair value on a non-recurring basis at June 30, 2018 compared to none at December 31, 2017.

The Corporation had an impaired residential mortgage loan totaling \$67,000 and an impaired home equity loan totaling \$7,000 at June 30, 2018 which were classified as TDRs and measured using a discounted cash flow methodology. At December 31, 2017 these loans were valued at \$68,000 and \$8,000, respectively.



## 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, 2018 and December 31, 2017:

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Measurements using:			
		Total	Level 1	Level 2	Level 3
June 30, 2018:					
Financial Assets:					
Cash and cash equivalents	\$30,576	\$30,576	\$30,576	\$—	\$—
Securities - available for sale	99,886	99,886	4,411	91,975	3,500
Securities - equities	474	474	474	—	—
Loans held for sale	—	—	—	—	—
Loans, net	587,258	578,642	—	—	578,642
Federal bank stock	4,403	N/A	N/A	N/A	N/A
Accrued interest receivable	2,250	2,250	65	382	1,803
	\$724,847	\$711,828	\$35,526	\$92,357	\$583,945
Financial Liabilities:					
Deposits	685,551	687,403	515,638	171,765	—
Borrowed funds	20,050	19,653	—	19,653	—
Accrued interest payable	410	410	32	378	—
	\$706,011	\$707,466	\$515,670	\$191,796	\$—
December 31, 2017:					
Financial Assets:					
Cash and cash equivalents	\$14,374	\$14,374	\$14,374	\$—	\$—
Securities - available for sale	99,350	99,350	4,472	86,880	7,998
Securities - equities	1,817	1,817	1,683	—	134
Loans held for sale	504	504	—	504	—
Loans, net	577,234	577,616	—	—	577,616
Federal bank stock	4,662	—	N/A	N/A	N/A
Accrued interest receivable	2,217	2,217	59	338	1,820
	\$700,158	\$695,878	\$20,588	\$87,722	\$587,568
Financial Liabilities:					
Deposits	654,643	657,414	483,956	173,458	—
Borrowed funds	26,000	25,499	—	25,499	—
Accrued interest payable	413	413	23	390	—
	\$681,056	\$683,326	\$483,979	\$199,347	\$—



## 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.

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 2018 is 1.875% and was 1.25% for 2017 and 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, 2018, 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, 2018, 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.

(Dollar amounts in thousands)	June 30, 2018		December 31, 2017	
	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets:				
Actual	\$65,901	13.26%	\$64,221	12.96%
For capital adequacy purposes	39,759	8.00%	39,630	8.00%
To be well capitalized	49,699	10.00%	49,537	10.00%
Tier 1 capital to risk-weighted assets:				
Actual	\$59,783	12.03%	\$58,088	11.73%
For capital adequacy purposes	29,820	6.00%	29,722	6.00%
To be well capitalized	39,759	8.00%	39,630	8.00%
Common Equity Tier 1 capital to risk-weighted assets:				
Actual	\$59,783	12.03%	\$58,088	11.73%
For capital adequacy purposes	22,365	4.50%	22,292	4.50%
To be well capitalized	32,305	6.50%	32,199	6.50%
Tier 1 capital to average assets:				

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Actual	\$59,783	7.87	%	\$58,088	7.71	%
For capital adequacy purposes	30,372	4.00	%	30,117	4.00	%
To be well capitalized	37,965	5.00	%	37,647	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, 2018 and 2017 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, 2018	\$ (1,881 )	\$ (4,839 )	\$ (6,720 )
Other comprehensive income before reclassification	(237 )	—	(237 )
Amounts reclassified from accumulated other comprehensive income (loss)	1	—	1
Net current period other comprehensive income	(236 )	—	(236 )
Accumulated Other Comprehensive Income (Loss) at June 30, 2018	\$ (2,117 )	\$ (4,839 )	\$ (6,956 )

(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, 2018	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ (2 )	Net gain (loss) on sale of securities
	1	Provision for income taxes
Total reclassifications for the period	\$ (1 )	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, 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 )



## 10. Accumulated Other Comprehensive Income (Loss)

(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 Comprehensive 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

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, 2018 and 2017 and summarized 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 December 31, 2017	\$ (679 )	\$(4,839)	\$(5,518)
Cumulative effect of change in accounting principle for marketable equity securities, net of tax	(187 )	—	(187 )
Accumulated Other Comprehensive Income (Loss) at January 1, 2018, as adjusted	\$ (866 )	\$(4,839)	\$(5,705)
Other comprehensive income before reclassification	(1,275 )	—	(1,275 )
Amounts reclassified from accumulated other comprehensive income (loss)	24	—	24
Net current period other comprehensive income	(1,251 )	—	(1,251 )
Accumulated Other Comprehensive Income (Loss) at June 30, 2018	(2,117 )	(4,839 )	(6,956 )

(Dollar amount in thousands)

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated	Affected Line Item in the Statement Where Net Income is Presented
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	Other Comprehensive Income For the six months ended June 30, 2018	
Unrealized gains and losses on available-for-sale securities	(31 )	Net gain (loss) on sale of available-for-sale securities
Unrealized gains and losses on available-for-sale securities	—	Other than temporary impairment losses
	7	Provision for income taxes
Total reclassifications for the period	(24 )	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 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	372	—	372
Accumulated Other Comprehensive Income (Loss) at June 30, 2017	\$ (307 )	\$(3,812)	\$(4,119)

(Dollar amount in thousands)

Details about Accumulated Other Comprehensive Income 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
Total reclassifications for the period	54 (104 )	Provision for income taxes Net of tax

## 11. Revenue Recognition

On January 1, 2018, the Corporation adopted ASU 2014-09 "Revenue from Contracts with Customers" (Topic 606) and all subsequent ASUs that modified Topic 606. Interest income, net securities gains (losses) and bank-owned life insurance are not included within the scope of Topic 606. For the revenue streams in the scope of Topic 606, service charges on deposits and electronic banking fees, there are no significant judgments related to the amount and timing of revenue recognition. All of the Corporation's revenue from contracts with customers is recognized within noninterest income.

Service charges on deposits: The Corporation earns fees from its deposit customers for transaction-based, account maintenance and overdraft services. Transaction-based fees, which include services such as stop payment charges, statement rendering and other fees, are recognized at the time the transaction is executed as that is the point in time the Corporation fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Corporation satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Electronic banking fees: The Corporation earns interchange and other ATM related fees from cardholder transactions conducted through the various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The gross amount of these fees are processed through noninterest income. Other fees, such as transaction surcharges and card replacement fees are withdrawn from the customer's account balance at the time of service.

The following table presents the Corporation's sources of noninterest income for the three and six months ended June 30, 2018 and 2017.

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(Dollar amount in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Noninterest income				
In-scope of Topic 606:				
Service charges on deposits				
Maintenance fees	\$37	\$38	\$76	\$78
Overdraft fees	353	326	682	624
Other fees	73	71	142	141
Electronic banking fees	329	292	644	562
Noninterest income (in-scope of Topic 606)	792	727	1,544	1,405
Noninterest income (out-of-scope of Topic 606) <sup>(1)</sup>	257	141	403	318
Total noninterest income	\$1,049	\$868	\$1,947	\$1,723

(1) Noninterest income items that are out-of-scope include net realized gains (losses) on sales of securities, net gains (losses) on sales of loans, earnings on bank-owned life insurance and certain other noninterest income items.

## 12. Recent Accounting Pronouncements

### Newly Issued Not Yet Effective Accounting Standards

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 analyzing data on leased assets. The adoption of this guidance is expected to increase both assets and liabilities, but is not expected to have a material impact on the consolidated statement of income.

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.



## 12. Recent Accounting Pronouncements (continued)

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 2017-08, "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 2017-08 on its financial statements and disclosures.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." The amendments in this Update are to better reflect the economic results of hedging in the financial statements along with simplification of certain hedge accounting requirements. Specifically, the entire change in the fair value of the hedging instrument is required to be presented in the same income statement line as and in the same period that the earnings effect of the hedged item is recognized. Therefore, hedge ineffectiveness will not be reported separately or in a different period. In addition, hedge effectiveness can be determined qualitatively in periods following inception. The amendments permit an entity to measure the change in fair value of the hedged item on the basis of the benchmark rate component. They also permit an entity to measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that reflects only the designated cash flows being hedged. For a closed portfolio of prepayable financial assets, an entity is permitted to designate the amount that is not expected to be affected by prepayments or defaults as the hedged item. For public business entities, the new guidance is effective for fiscal years beginning after December 15, 2018, and interim periods therein. Early adoption is permitted. 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.

## Adoption of New Accounting Policies

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 adoption of the new guidance did not have a material impact on the consolidated financial statements.

## 12. Recent Accounting Pronouncements (continued)

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. The guidance does not apply to revenue associated with financial instruments, including loans and securities. The Corporation has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Corporation generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. The Corporation has evaluated revenue streams within noninterest income to assess the applicability of this guidance and determined that service charges on deposits and electronic banking fees within the scope of this ASU. Because performance obligations are satisfied as services are rendered and the fees are fixed, there is little judgment involved in applying the guidance that significantly affects the determination of the amount and timing of revenue from contracts with customers. The adoption of this guidance on January 1, 2018 did not have a material impact on the Corporation's financial statements.

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 was effective for interim and annual periods beginning after December 15, 2017. The adoption of ASU 2016-1 did not have a significant impact 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 was effective for fiscal years beginning after December 15, 2017. The adoption of ASU 2016-15 did not have an impact 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 Emclaire Financial Corp and its wholly owned subsidiaries for the six months ended June 30, 2018, compared to the same period in 2017 and should be read in conjunction with the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC and with the accompanying consolidated financial statements and notes presented in 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 \$25.2 million to \$775.3 million at June 30, 2018 from \$750.1 million at December 31, 2017. Asset growth was driven by increases in cash and equivalents and net loans receivable of \$16.2 million and \$9.5 million, respectively. Total liabilities increased \$24.8 million to \$715.8 million at June 30, 2018 from \$691.0 million at December 31, 2017, resulting primarily from a \$30.9 million, or 4.7%, increase in customer deposits, partially offset by a \$6.0 million decrease in borrowed funds. Deposit growth consisted of a \$27.9 million, or 5.3%, increase in interest bearing deposits and a \$3.0 million, or 2.4%, increase in non-interest bearing deposits.

Stockholders' equity increased \$402,000 to \$59.5 million at June 30, 2018 from \$59.1 million at December 31, 2017 primarily due to a \$1.7 million increase in retained earnings as a result of \$2.8 million of net income, partially offset by \$1.3 million of common dividends paid, and a \$1.4 million decrease in accumulated other comprehensive income. The Corporation remains well capitalized and is positioned for continued growth with total stockholders' equity at 7.7% of total assets. Tangible book value per common share was \$21.51 at June 30, 2018, compared to \$21.28 at December 31, 2017.

At June 30, 2018, 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 7.87%, 12.03%, 12.03% and 13.26%, respectively. The Bank was also considered "well-capitalized" at December 31, 2017 with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.71%, 11.73%, 11.73% and 12.96%, respectively.

## RESULTS OF OPERATIONS

### Comparison of Results for the Three Months Ended June 30, 2018 and 2017

General. Net income increased \$372,000, or 35.7%, to \$1.4 million for the three months ended June 30, 2018 from \$1.0 million for the same period in 2017. This increase was the result of increases in net interest income and noninterest income \$826,000 and \$181,000, respectively, and a decrease of \$32,000 in the provision for income taxes, partially offset by increases in noninterest expense and the provision for loan losses of \$568,000 and \$99,000, respectively.

Net interest income. Tax equivalent net interest income increased \$744,000, or 13.5%, to \$6.2 million for the three months ended June 30, 2018 from \$5.5 million for the three months ended June 30, 2017. This increase was attributed to an increase in tax equivalent interest income of \$920,000, partially offset by an increase in interest expense of \$176,000.

Interest income. Tax equivalent interest income increased \$920,000, or 14.0%, to \$7.5 million for the three months ended June 30, 2018 from \$6.6 million for the same period in 2017. This increase was attributed to increases in interest earned on loans and interest-earning deposits with banks, dividends on federal bank stocks and interest earned on securities of \$826,000, \$45,000, \$32,000 and \$17,000, respectively.

Tax equivalent interest earned on loans receivable increased \$826,000, or 14.0%, to \$6.7 million for the three months ended June 30, 2018 compared to \$5.9 million for the same period in 2017. This increase resulted from a \$45.5 million, or 8.3%, increase in average loans, accounting for an increase of \$505,000 in interest income. The increase in loans receivable was related to the acquisition of Northern Hancock Bank and Trust Co. (Northern Hancock) in September 2017 and strong loan growth achieved in late 2017 and the first six months of 2018. Also included in interest earned on loans receivable for the three months ended June 30, 2018, the Corporation recorded \$113,000 of recovered interest related to the payoff of a nonperforming loan relationship totaling \$789,000. Adding to this

favorable volume variance, the average yield on loans increased 23 basis points to 4.54% for the three months ended June 30, 2018, versus 4.31% for the same period in 2017. This favorable yield variance accounted for a \$321,000 increase in interest income.

Tax equivalent interest earned on securities increased \$17,000, or 2.9%, to \$602,000 for the three months ended June 30, 2018 compared to \$585,000 for the three months ended June 30, 2017. This increase resulted from a 10 basis point increase in the average yield on securities to 2.47% for the three months ended June 30, 2018 versus 2.37% for the same period in 2017. This favorable yield variance accounted for a \$24,000 increase in interest income. Partially offsetting this favorable variance, the average balance of securities decreased \$1.2 million, accounting for a \$7,000 decrease in interest income.

Interest earned on deposits with banks increased \$45,000 to \$83,000 for the three months ended June 30, 2018 compared to \$38,000 for the three months ended June 30, 2017. This increase resulted from a 52 basis point increase in the average yield on these accounts to 1.37% for the three months ended June 30, 2018, versus 0.85% for the same period in 2017, accounting for a \$29,000 increase in interest income. Additionally, the average balance of interest-earning deposits increased \$5.8 million, or 25.3%, accounting for an increase of \$16,000 in interest income.

Dividends on federal bank stocks increased \$32,000, or 52.5%, to \$93,000 for the three months ended June 30, 2018 from \$61,000 for the same period in 2017. This increase was primarily due to an increase of 342 basis points in the average yield on federal bank stocks to 8.52% for the three months ended June 30, 2018, versus 5.10% for the same period in 2017, accounting for a \$38,000 increase in interest income. The increase in the average yield resulted from recent increases in the dividend rate paid on Federal Home Loan Bank stock. Partially offsetting the favorable yield variance, the average balance of federal bank stocks decreased \$418,000, or 8.7%, accounting for a \$6,000 decrease in interest income.

Interest expense. Interest expense increased \$176,000, or 16.5%, to \$1.2 million for the three months ended June 30, 2018 from \$1.1 million for the same period in 2017. This increase in interest expense can be attributed to a \$353,000 increase in interest incurred on deposits, partially offset by a decrease of \$177,000 in interest incurred on borrowed funds.

Interest expense incurred on deposits increased \$353,000, or 47.1%, to \$1.1 million for the three months ended June 30, 2018 compared to \$749,000 for the same period in 2017. The average cost of interest-bearing deposits increased 18 basis points to 0.80% for the three months ended June 30, 2018, versus 0.62% for the same period in 2017, accounting for a \$236,000 increase in interest expense. Additionally, the average balance of interest-bearing deposits increased \$68.6 million, or 14.3%, to \$550.0 million for the three months ended June 30, 2018, compared to \$481.4 million for the same period in 2017 causing a \$117,000 increase in interest expense. This increase was primarily due to the acquisition of Northern Hancock in September 2017 and strong deposit growth during late 2017 and the first six months of 2018.

Interest expense incurred on borrowed funds decreased \$177,000, or 55.7%, to \$141,000 for the three months ended June 30, 2018, compared to \$318,000 for the same period in the prior year. The average balance of borrowed funds decreased \$20.9 million, or 51.1%, to \$20.1 million for the three months ended June 30, 2018, compared to \$41.0 million for the same period in 2017 causing a \$143,000 decrease in interest expense. The reduction in the outstanding balance of borrowed funds resulted from the payoff of maturing FHLB long-term notes of \$15.0 million in November 2017 and the early payoff of a \$5.0 million FHLB long-term note in February 2018. In addition, the average cost of borrowed funds decreased 29 basis points to 2.82% for the three months ended June 30, 2018 compared to 3.11% for the same period in 2017 causing a \$34,000 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,					
	2018			2017		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Interest-earning assets:						
Loans, taxable	\$571,306	\$6,514	4.57%	\$523,363	\$5,610	4.30%
Loans, tax exempt	21,022	194	3.70%	23,454	272	4.65%
Total loans receivable	592,328	6,708	4.54%	546,817	5,882	4.31%
Securities, taxable	73,199	439	2.41%	73,694	392	2.13%
Securities, tax exempt	24,660	163	2.65%	25,347	193	3.04%
Total securities	97,859	602	2.47%	99,041	585	2.37%
Interest-earning deposits with banks	24,225	83	1.37%	18,035	38	0.85%
Federal bank stocks	4,380	93	8.52%	4,798	61	5.10%
Total interest-earning cash equivalents	28,605	176	2.47%	22,833	99	1.74%
Total interest-earning assets	718,792	7,486	4.18%	668,691	6,566	3.94%
Cash and due from banks	2,837			2,679		
Other noninterest-earning assets	46,462			45,805		
Total Assets	\$768,091			\$717,175		
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$379,094	\$470	0.50%	\$316,823	\$200	0.25%
Time deposits	170,902	632	1.48%	164,530	549	1.34%
Total interest-bearing deposits	549,996	1,102	0.80%	481,353	749	0.62%
Borrowed funds, short-term	2,050	29	5.73%	3,037	29	3.83%
Borrowed funds, long-term	18,003	112	2.48%	37,950	289	3.04%
Total borrowed funds	20,053	141	2.82%	40,987	318	3.11%
Total interest-bearing liabilities	570,049	1,243	0.87%	522,340	1,067	0.82%
Noninterest-bearing demand deposits	128,578	—	—	129,775	—	—
Funding and cost of funds	698,627	1,243	0.71%	652,115	1,067	0.66%
Other noninterest-bearing liabilities	10,344			9,398		

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Total Liabilities	708,971	661,513
Stockholders' Equity	59,120	55,662
Total Liabilities and Stockholders' Equity	\$768,091	\$717,175
Net interest income	\$6,243	\$5,499
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)	3.30%	3.12%
Net interest margin (net interest income as a percentage of average interest-earning assets)	3.48%	3.30%

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

(Dollar amounts in thousands)	Three months ended June 30, 2018 versus 2017 Increase (Decrease) due to		
	Volume	Rate	Total
Interest income:			
Loans	\$505	\$321	\$826
Securities	(7 )	24	17
Interest-earning deposits with banks	16	29	45
Federal bank stocks	(6 )	38	32
Total interest-earning assets	508	412	920
Interest expense:			
Interest-bearing deposits	117	236	353
Borrowed funds, short-term	(12 )	12	—
Borrowed funds, long-term	(131 )	(46 )	(177 )
Total interest-bearing liabilities	(26 )	202	176
Net interest income	\$534	\$210	\$744

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, 2018 and 2017 is as follows:

(Dollar amounts in thousands)	As of or for the three months ended June 30,	
	2018	2017
Balance at the beginning of the period	\$5,935	\$5,688
Provision for loan losses	300	201
Charge-offs	(147 )	(128 )
Recoveries	30	6
Balance at the end of the period	\$6,118	\$5,767
Nonperforming loans	\$2,486	\$3,045
Nonperforming assets	3,304	3,251
Nonperforming loans to total loans	0.42 %	0.55 %
Nonperforming assets to total assets	0.43 %	0.44 %
Allowance for loan losses to total loans	1.03 %	1.05 %
Allowance for loan losses to nonperforming loans	246.10 %	189.39 %

Nonperforming loans decreased \$671,000, or 21.3%, to \$2.5 million at June 30, 2018 from \$3.2 million at March 31, 2018. This decrease was primarily due to the payoff of a commercial relationship totaling \$789,000 during the three months ended June 30, 2018. Of the \$2.5 million in nonperforming loans, \$604,000 were not 30 days or more past due at June 30, 2018.

As of June 30, 2018, the Corporation's classified and criticized assets amounted to \$14.3 million, or 1.9% of total assets, with \$10.3 million classified as substandard and \$4.1 million identified as special mention. This compares to classified and criticized assets of \$15.6 million, or 2.1% of total assets, with \$11.0 million classified as substandard and \$4.6 million identified as special mention at March 31, 2018. This decrease was primarily related to the payoff of two commercial loan relationships totaling \$1.1 million, including the aforementioned \$789,000 nonperforming relationship, during the quarter ending June 30, 2018.

The provision for loan losses increased \$99,000, or 49.3%, to \$300,000 for the three months ended June 30, 2018 from \$201,000 for the same period in 2017 due primarily to general growth in the loan portfolio experienced in the second quarter of 2018.

Noninterest income. Noninterest income increased \$181,000, or 20.9%, to \$1.0 million for the three months ended June 30, 2018, compared to \$868,000 for the same period in 2017. 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. Partially offsetting the impairment charge, the Corporation realized security gains of \$350,000 during the quarter ended June 30, 2017. Fees and service charges increased \$28,000 as overdraft charges for the three months ended June 30, 2018 outpaced the same period in the prior year and other income increased \$117,000 due to increased interchange fee income and fair value adjustments related to the Corporation's equity securities. Partially offsetting these favorable items, gains on the sale of loans totaled \$2,000 for the quarter ended June 30, 2018, compared to \$124,000 for the same period in 2017.

Noninterest expense. Noninterest expense increased \$568,000, or 12.1%, to \$5.2 million for the three months ended June 30, 2018 compared to \$4.7 million for the same period in 2017. This increase in noninterest expense can be

attributed primarily to increases in acquisition costs, compensation and benefits, federal deposit insurance, professional fees and premises and equipment of \$252,000, \$174,000, \$49,000, \$38,000 and \$32,000 respectively.

Acquisition costs increased \$252,000 for the three months ended June 30, 2018 compared to the same period in 2017. Costs related to the pending acquisition of Community First totaled \$358,000 for the three months ended June 30, 2018, while costs related to the acquisition of Northern Hancock totaled \$106,000 for the three months ended June 30, 2017.

Compensation and employee benefits increased \$174,000, or 7.4%, to \$2.5 million for the three months ended June 30, 2018 compared to \$2.3 million for the same period in 2017. This increase was primarily the result of increases in salaries, stock compensation expense and insurance benefits of \$132,000, \$20,000 and \$11,000, respectively. These increases are primarily related



to costs associated with the operation of the new full-service banking office in Chester, West Virginia which was acquired from Northern Hancock, increased health insurance costs and normal salary and benefit increases.

Provision for income taxes. The provision for income taxes decreased \$32,000, or 10.2%, to \$282,000 for the three months ended June 30, 2018 compared to \$314,000 for the same period in the prior year. This related to a decrease in the Corporation's effective tax rate to 16.6% for the three months ended June 30, 2018 compared to 23.2% for the same period in 2017, partially offset by an increase in net income before income taxes. The decrease in the Corporation's effective tax rate was due to the enactment of the Tax Cuts and Job Act in December 2017 and the reduction of the corporate income tax rate from a maximum of 35% to a flat 21%.

#### Comparison of Results for the Six Months Ended June 30, 2018 and 2017

General. Net income increased \$778,000, or 38.9%, to \$2.8 million for the six months ended June 30, 2018 from \$2.0 million for the same period in 2017. This increase was the result of increases in net interest income and noninterest income \$1.5 million and \$224,000, respectively, and a decrease of \$38,000 in the provision for income taxes, partially offset by increases in noninterest expense and the provision for loan losses of \$683,000 and \$317,000, respectively.

Net interest income. Tax equivalent net interest income increased \$1.4 million, or 12.5%, to \$12.1 million for the six months ended June 30, 2018 from \$10.8 million for the six months ended June 30, 2017. This increase was attributed to an increase in tax equivalent interest income of \$1.7 million, partially offset by an increase in interest expense of \$308,000.

Interest income. Tax equivalent interest income increased \$1.7 million, or 12.9%, to \$14.5 million for the six months ended June 30, 2018 from \$12.9 million for the same period in 2017. This increase was attributed to increases in interest earned on loans and interest-earning deposits with banks, dividends on federal bank stocks and interest earned on securities of \$1.5 million, \$64,000, \$42,000 and \$8,000, respectively.

Tax equivalent interest earned on loans receivable increased \$1.5 million, or 13.4%, to \$13.1 million for the six months ended June 30, 2018 compared to \$11.5 million for the same period in 2017. This increase resulted from a \$47.8 million, or 8.8%, increase in average loans, accounting for a \$1.0 million increase in interest income. The increase in loans receivable was related to the acquisition of Northern Hancock in September 2017 and strong loan growth achieved in late 2017 and the first six months of 2018. Adding to this favorable volume variance, the average yield on loans increased 18 basis points to 4.48% for the six months ended June 30, 2018, versus 4.30% for the same period in 2017. This favorable yield variance accounted for a \$499,000 increase in interest income. Included in interest earned on loans receivable for the six months ended June 30, 2018, the Corporation recorded \$113,000 of recovered interest related to the payoff of a nonperforming loan relationship totaling \$789,000

Tax equivalent interest earned on securities increased \$8,000 to \$1.2 million for the six months ended June 30, 2018 and June 30, 2017. This increase resulted from a 3 basis point increase in the average yield on securities to 2.42% for the six months ended June 30, 2018 versus 2.39% for the same period in 2017. This favorable yield variance accounted for an \$18,000 increase in interest income. Partially offsetting this favorable variance, the average balance of securities decreased \$799,000, accounting for a \$10,000 decrease in interest income.

Interest earned on deposits with banks increased \$64,000 to \$117,000 for the six months ended June 30, 2018 compared to \$53,000 for the six months ended June 30, 2017. This increase resulted from a 50 basis point increase in the average yield on these accounts to 1.29% for the six months ended June 30, 2018, versus 0.79% for the same period in 2017, accounting for a \$42,000 increase in interest income. Additionally, the average balance of interest-earning deposits increased \$4.7 million, or 34.7%, accounting for an increase of \$22,000 in interest income.

Dividends on federal bank stocks increased \$42,000, or 36.5%, to \$157,000 for the six months ended June 30, 2018 from \$115,000 for the same period in 2017. This increase was primarily due to an increase of 232 basis points in the average yield on federal bank stocks to 7.09% for the six months ended June 30, 2018, versus 4.77% for the same period in 2017, accounting for a \$52,000 increase in interest income. The increase in the average yield resulted from recent increases in the dividend rate paid on Federal Home Loan Bank stock. Partially offsetting the favorable yield variance, the average balance of federal bank stocks decreased \$397,000, or 8.2%, accounting for a \$10,000 decrease in interest income.

Interest expense. Interest expense increased \$308,000, or 14.8%, to \$2.4 million for the six months ended June 30, 2018 from \$2.1 million for the same period in 2017. This increase in interest expense can be attributed to a \$641,000 increase in interest incurred on deposits, partially offset by a decrease of \$333,000 in interest incurred on borrowed funds.

Interest expense incurred on deposits increased \$641,000, or 44.1%, to \$2.1 million for the six months ended June 30, 2018 compared to \$1.5 million for the same period in 2017. The average cost of interest-bearing deposits increased 16 basis points to

0.78% for the six months ended June 30, 2018, versus 0.62% for the same period in 2017, accounting for a \$414,000 increase in interest expense. Additionally, the average balance of interest-bearing deposits increased \$67.8 million, or 14.3%, to \$541.3 million for the six months ended June 30, 2018, compared to \$473.4 million for the same period in 2017 causing a \$227,000 increase in interest expense. This increase was primarily due to the acquisition of Northern Hancock in September 2017 and strong deposit growth during late 2017 and the first six months of 2018.

Interest expense incurred on borrowed funds decreased \$333,000, or 52.7%, to \$299,000 for the six months ended June 30, 2018, compared to \$632,000 for the same period in the prior year. The average balance of borrowed funds decreased \$20.4 million, or 47.8%, to \$22.3 million for the six months ended June 30, 2018, compared to \$42.7 million for the same period in 2017 causing a \$59,000 decrease in interest expense. The reduction in the outstanding balance of borrowed funds resulted from the payoff of maturing FHLB long-term notes of \$15.0 million in November 2017 and the early payoff of a \$5.0 million FHLB long-term note in February 2018. In addition, the average cost of borrowed funds decreased 28 basis points to 2.70% for the six months ended June 30, 2018 compared to 2.98% for the same period in 2017 causing a \$274,000 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)	Six months ended June 30,					
	2018			2017		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$567,139	\$12,687	4.51%	\$517,064	\$10,984	4.28%
Loans, tax exempt	21,355	388	3.67%	23,619	544	4.64%
Total loans receivable	588,494	13,075	4.48%	540,683	11,528	4.30%
Securities, taxable	72,665	847	2.35%	73,498	787	2.16%
Securities, tax exempt	25,998	338	2.62%	25,964	390	3.02%
Total securities	98,663	1,185	2.42%	99,462	1,177	2.39%
Interest-earning deposits with banks	18,287	117	1.29%	13,579	53	0.79%
Federal bank stocks	4,466	157	7.09%	4,863	115	4.77%
Total interest-earning cash equivalents	22,753	274	2.43%	18,442	168	1.84%
Total interest-earning assets	709,910	14,534	4.13%	658,587	12,873	3.94%
Cash and due from banks	2,748			2,664		
Other noninterest-earning assets	46,071			46,190		
<b>Total Assets</b>	<b>\$758,729</b>			<b>\$707,441</b>		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$370,486	\$873	0.48%	\$311,276	\$370	0.24%
Time deposits	170,771	1,220	1.44%	162,152	1,082	1.35%
Total interest-bearing deposits	541,257	2,093	0.78%	473,428	1,452	0.62%
Borrowed funds, short-term	3,207	66	4.12%	6,627	71	2.16%
Borrowed funds, long-term	19,122	233	2.46%	36,119	561	3.12%
Total borrowed funds	22,329	299	2.70%	42,746	632	2.98%
Total interest-bearing liabilities	563,586	2,392	0.86%	516,174	2,084	0.81%
Noninterest-bearing demand deposits	125,768	—	—	126,859	—	—
Funding and cost of funds	689,354	2,392	0.70%	643,033	2,084	0.65%
Other noninterest-bearing liabilities	10,376			9,354		

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Total Liabilities	699,730	652,387
Stockholders' Equity	58,999	55,054
Total Liabilities and Stockholders' Equity	\$758,729	\$707,441
Net interest income	\$12,142	\$10,789
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)	3.27%	3.13%
Net interest margin (net interest income as a percentage of average interest-earning assets)	3.45%	3.30%

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)	Six months ended June 30, 2018 versus 2017		
	Increase (Decrease) due to		
	Volume	Rate	Total
Interest income:			
Loans	\$1,048	\$499	\$1,547
Securities	(10 )	18	8
Interest-earning deposits with banks	22	42	64
Federal bank stocks	(10 )	52	42
Total interest-earning assets	1,050	611	1,661
Interest expense:			
Interest-bearing deposits	227	414	641
Borrowed funds, short-term	(48 )	43	(5 )
Borrowed funds, long-term	(226 )	(102 )	(328 )
Total interest-bearing liabilities	(47 )	355	308
Net interest income	\$1,097	\$256	\$1,353

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, 2018 and 2017 is as follows:

(Dollar amounts in thousands)	As of or for the six months ended	
	June 30,	
	2018	2017
Balance at the beginning of the period	\$6,127	\$5,545
Provision for loan losses	680	363
Charge-offs	(732 )	(174 )
Recoveries	43	33
Balance at the end of the period	\$6,118	\$5,767
Nonperforming loans	\$2,486	\$3,045
Nonperforming assets	3,304	3,251
Nonperforming loans to total loans	0.42 %	0.55 %
Nonperforming assets to total assets	0.43 %	0.44 %
Allowance for loan losses to total loans	1.03 %	1.05 %
Allowance for loan losses to nonperforming loans	246.10 %	189.39 %

Nonperforming loans decreased \$1.2 million, or 32.7%, to \$2.5 million at June 30, 2018 from \$3.7 million at December 31, 2017. This decrease was primarily due to the transfer of a \$559,000 commercial mortgage to OREO and the payoff of a \$789,000 commercial relationship during the six months ended June 30, 2018. Of the \$2.5 million in nonperforming loans, \$604,000 were not 30 days or more past due at June 30, 2018.

As of June 30, 2018, the Corporation's classified and criticized assets amounted to \$14.3 million, or 1.9% of total assets, with \$10.3 million classified as substandard and \$4.1 million identified as special mention. This compares to classified and criticized assets of \$14.8 million, or 2.0% of total assets, with \$11.6 million classified as substandard and \$3.2 million identified as special mention at December 31, 2017. This decrease was primarily related to the risk rating upgrade of one \$1.9 million commercial loan relationship, the payoff of two commercial loan relationships totaling \$1.1 million, and the aforementioned \$559,000 loan transferred to OREO. These favorable changes to the Corporation's classified and criticized assets were partially offset by the risk rating downgrades of two commercial loan relationships to special mention and substandard.

The provision for loan losses increased \$317,000, or 87.3%, to \$680,000 for the six months ended June 30, 2018 from \$363,000 for the same period in 2017 due primarily to general growth in the loan portfolio and higher than normal charge-offs experienced during the first six months of 2018.

Noninterest income. Noninterest income increased \$224,000, or 13.0%, to \$1.9 million for the six months ended June 30, 2018 from \$1.7 million for the same period in 2017. During the six months 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. Partially offsetting the impairment charge, the Corporation realized security gains of \$350,000 during the six months ended June 30, 2017. During the six months ended June 30, 2018, the Corporation realized security losses of \$31,000. Additionally, fees and service charges increased \$58,000 as overdraft charges for the six months ended June 30, 2018 outpaced the same period in the prior year and other income increased \$140,000 due to increased interchange fee income and fair value adjustments related to the Corporation's equity securities. Partially offsetting these favorable items, gains on the sales of loans totaled \$24,000 for the six months ended June 30, 2018, compared to \$130,000 for the same period in 2017.

Noninterest expense. Noninterest expense increased \$683,000, or 7.4%, to \$10.0 million for the six months ended June 30, 2018 compared to \$9.3 million for the same period in 2017. This increase in noninterest expense can be attributed to increases in compensation and benefits, acquisition costs, federal deposit insurance, and professional fees of \$304,000, \$251,000, \$78,000, and \$53,000, respectively.

Compensation and employee benefits increased \$304,000, or 6.5%, to \$5.0 million for the six months ended June 30, 2018 compared to \$4.7 million for the same period in 2017. This increase was primarily the result of increases in salaries, insurance benefits and



stock compensation expense of \$165,000, \$58,000 and \$41,000, respectively. These increases are primarily related to costs associated with the operation of the new full-service banking office in Chester, West Virginia which was acquired from Northern Hancock, increased health insurance costs and normal salary and benefit increases.

Acquisition costs increased \$251,000 for the six months ended June 30, 2018 compared to the same period in 2017. Costs related to the pending acquisition of Community First totaled \$358,000 for the six months ended June 30, 2018, while costs related to the acquisition of Northern Hancock totaled \$107,000 for the six months ended June 30, 2017.

Provision for income taxes. The provision for income taxes decreased \$38,000, or 6.5%, to \$548,000 for the six months ended June 30, 2018 compared to \$586,000 for the same period in the prior year. This related to an decrease in the Corporation's effective tax rate to 16.5% for the six months ended June 30, 2018 compared to 22.7% for the same period in 2017, partially offset by an increase in net income before income taxes. The decrease in the Corporation's effective tax rate was due to the enactment of the Tax Cuts and Job Act in December 2017 and the reduction of the corporate income tax rate from a maximum of 35% to a flat 21%.

## 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, 2018, the Corporation used its sources of funds primarily to fund loan advances and repay long-term borrowed funds. As of June 30, 2018, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$102.6 million, and standby letters of credit totaling \$199,000, net of collateral maintained by the Bank.

At June 30, 2018, time deposits amounted to \$169.9 million, or 24.7% of the Corporation's total consolidated deposits, including approximately \$46.5 million of which are scheduled to mature within the next year. Management of the Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation 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, 2018, the Corporation had borrowed funds of \$20.1 million consisting of \$15.0 million of long-term FHLB advances, a \$3.0 million long-term advance with a correspondent bank and \$2.1 million outstanding on a line of credit with a correspondent bank. At June 30, 2018, 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 \$186.7 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, 2018, 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, 2017. 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, 2017, 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, 2018, the Corporation's interest-earning assets maturing or repricing within one year totaled \$202.0 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$160.2 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$41.8 million. At June 30, 2018, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 126.1%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2017.

### 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, 2018, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective. There have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

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

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

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

#### Item 1A. Risk Factors

Not applicable.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Mine Safety Disclosures

Not applicable.

### Item 5. Other Information

(a) Not applicable.

(b) Not applicable.

### Item 6. Exhibits

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

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

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

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

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definitions Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EMCLAIRE  
FINANCIAL CORP

Date: August 10, 2018 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: August 10, 2018 By: /s/ Amanda L. Engles  
Amanda L. Engles  
Chief Financial Officer  
Treasurer