

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
November 13, 2017

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

FORM 10-Q  
(Mark One)

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

For the quarterly period ended September 30, 2017

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

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

Commission File Number: 001-34527

EMCLAIRE FINANCIAL CORP  
(Exact name of registrant as specified in its charter)

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

612 Main Street, Emlenton, Pennsylvania 16373  
(Address of principal executive offices) (Zip Code)  
(844) 767-2311  
(Registrant's telephone number)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated

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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 2,264,389 at November 12, 2017.

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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 September 30, 2017 and December 31, 2016

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

|   | September 30,<br>2017 | December 31,<br>2016 |
|---|-----------------------|----------------------|
| Assets  |                       |                      |
| Cash and due from banks   | \$ 3,216              | \$ 2,758             |
| Interest earning deposits with banks  | 37,040                | 14,810               |
| Cash and cash equivalents   | 40,256                | 17,568               |
| Securities available for sale   | 101,301               | 101,560              |
| Loans held for sale   | —                     | 68                   |
| Loans receivable, net of allowance for loan losses of \$5,940 and \$5,545   | 574,736               | 515,435              |
| Federal bank stocks, at cost  | 4,906                 | 4,861                |
| Bank-owned life insurance   | 11,639                | 11,390               |
| Accrued interest receivable   | 2,228                 | 1,815                |
| Premises and equipment, net   | 18,405                | 18,282               |
| Goodwill  | 10,288                | 10,288               |
| Core deposit intangible, net  | 550                   | 560                  |
| Prepaid expenses and other assets   | 9,631                 | 10,308               |
| <b>Total Assets</b>   | <b>\$ 773,940</b>     | <b>\$ 692,135</b>    |
| Liabilities and Stockholders' Equity  |                       |                      |
| Liabilities:  |                       |                      |
| Deposits:   |                       |                      |
| Non-interest bearing  | \$ 129,870            | \$ 123,717           |
| Interest bearing  | 532,682               | 461,223              |
| Total deposits  | 662,552               | 584,940              |
| Short-term borrowed funds   | 2,500                 | 9,500                |
| Long-term borrowed funds  | 38,750                | 34,500               |
| Accrued interest payable  | 399                   | 239                  |
| Accrued expenses and other liabilities  | 9,986                 | 8,883                |
| <b>Total Liabilities</b>  | <b>714,187</b>        | <b>638,062</b>       |
| <b>Commitments and Contingent Liabilities</b>   | <b>—</b>              | <b>—</b>             |
| Stockholders' Equity:   |                       |                      |
| Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,366,406 and 2,254,375 shares issued; 2,264,389 and 2,152,358 shares outstanding, respectively | 2,958                 | 2,818                |

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|  |            |            |
|--|------------|------------|
| Additional paid-in capital                 | 30,974     | 27,900     |
| Treasury stock, at cost; 102,017 shares    | (2,114     | ) (2,114 ) |
| Retained earnings                          | 31,901     | 29,960     |
| Accumulated other comprehensive loss       | (3,966     | ) (4,491 ) |
| Total Stockholders' Equity                 | 59,753     | 54,073     |
| Total Liabilities and Stockholders' Equity | \$ 773,940 | \$ 692,135 |

See accompanying notes to consolidated financial statements.

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

|   | For the three<br>months ended<br>September 30, |          | For the nine months<br>ended September<br>30, |           |
|---|--|----------|---|-----------|
|   | 2017   | 2016     | 2017  | 2016      |
| Interest and dividend income:                       |  |          |   |           |
| Loans receivable, including fees                    | \$5,966  | \$ 5,444 | \$17,333                                      | \$ 15,331 |
| Securities:   |  |          |   |           |
| Taxable   | 421  | 396      | 1,208   | 1,270     |
| Exempt from federal income tax                      | 134  | 157      | 418   | 473       |
| Federal bank stocks                                 | 64   | 49       | 179   | 135       |
| Interest earning deposits with banks                | 98   | 48       | 151   | 110       |
| Total interest and dividend income                  | 6,683  | 6,094    | 19,289  | 17,319    |
| Interest expense:                                   |  |          |   |           |
| Deposits  | 824  | 781      | 2,276   | 2,091     |
| Borrowed funds                                      | 322  | 308      | 954   | 847       |
| Total interest expense                              | 1,146  | 1,089    | 3,230   | 2,938     |
| Net interest income                                 | 5,537  | 5,005    | 16,059  | 14,381    |
| Provision for loan losses                           | 270  | 168      | 633   | 470       |
| Net interest income after provision for loan losses | 5,267  | 4,837    | 15,426  | 13,911    |
| Noninterest income:                                 |  |          |   |           |
| Fees and service charges                            | 448  | 433      | 1,290   | 1,164     |
| Net gain on sales of available for sale securities  | —  | —        | 350   | 83        |
| Net gain on sales of loans                          | 46   | 121      | 176   | 121       |
| Other-than-temporary impairment loss                | —  | —        | (508)   | —         |
| Earnings on bank-owned life insurance               | 103  | 101      | 305   | 299       |
| Gain on bargain purchase                            | 1,307  | —        | 1,307   | —         |
| Other   | 370  | 357      | 1,076   | 1,067     |
| Total noninterest income                            | 2,274  | 1,012    | 3,996   | 2,734     |
| Noninterest expense:                                |  |          |   |           |
| Compensation and employee benefits                  | 2,288  | 2,259    | 6,957   | 6,484     |
| Premises and equipment                              | 718  | 732      | 2,203   | 2,110     |
| Intangible asset amortization                       | 58   | 60       | 177   | 165       |
| Professional fees                                   | 157  | 172      | 575   | 545       |
| Federal deposit insurance                           | 115  | 123      | 325   | 305       |
| Acquisition costs                                   | 963  | —        | 1,069   | 401       |
| Other   | 1,143  | 1,148    | 3,434   | 2,965     |
| Total noninterest expense                           | 5,442  | 4,494    | 14,740  | 12,975    |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Income before provision for income taxes    | 2,099     | 1,355     | 4,682     | 3,670     |
| Provision for income taxes                  | 392       | 297       | 978       | 880       |
| Net income                                  | \$1,707   | \$ 1,058  | \$3,704   | \$ 2,790  |
| Basic earnings per common share             | \$0.77    | \$ 0.49   | \$1.70    | \$ 1.30   |
| Diluted earnings per common share           | 0.77      | 0.49      | 1.69      | \$ 1.29   |
| Average common shares outstanding - basic   | 2,204,949 | 2,146,308 | 2,174,210 | 2,145,761 |
| Average common shares outstanding - diluted | 2,220,422 | 2,158,273 | 2,190,647 | 2,155,902 |

See accompanying notes to consolidated financial statements.



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

|   | For the three<br>months ended<br>September 30,<br>2017 |         | For the nine<br>months ended<br>September 30,<br>2016 |         |
|---|--|---------|---|---------|
|   | 2017   | 2016    | 2017  | 2016    |
| Net income  | \$1,707  | \$1,058 | \$3,704   | \$2,790 |
| Other comprehensive income  |  |         |   |         |
| Unrealized gains on securities:   |  |         |   |         |
| Unrealized holding gain arising during the period   | 232  | (271 )  | 638   | 1,760   |
| Reclassification adjustment for gains included in net income                                  | —  | —       | (350 )  | (83 )   |
| Reclassification adjustment for other than temporary impairment losses included in net income | —  | —       | 508   | —       |
|   | 232  | (271 )  | 796   | 1,677   |
| Tax effect  | (79 )  | 92      | (271 )  | (570 )  |
| Net of tax  | 153  | (179 )  | 525   | 1,107   |
| Comprehensive income  | \$1,860  | \$879   | \$4,229   | \$3,897 |

See accompanying notes to consolidated financial statements.

Emclaire Financial Corp  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
For the nine months ended September 30, 2017 and 2016  
(Dollar amounts in thousands)

|   | For the nine months<br>ended September<br>30, |          |
|---|---|----------|
|   | 2017  | 2016     |
| Cash flows from operating activities  |   |          |
| Net income  | \$3,704                                       | \$2,790  |
| Adjustments to reconcile net income to net cash provided by operating activities:   |   |          |
| Depreciation and amortization   | 864   | 835      |
| Provision for loan losses   | 633   | 470      |
| Amortization of premiums, net   | 367   | 300      |
| Amortization of intangible assets and mortgage servicing rights                     | 213   | 179      |
| Impairment loss on security recognized in earnings                                  | 508   | —        |
| Realized gains on sales of available for sale securities, net                       | (350 )  | (83 )    |
| Net gains on sales of loans   | (176 )  | (121 )   |
| Net gains on foreclosed real estate   | (10 )   | (17 )    |
| Gain on bargain purchase  | (1,307 )                                      | —        |
| Loss on sale of premises and equipment  | —   | 10       |
| Loans originated for sale   | (4,266 )                                      | (1,101 ) |
| Proceeds from the sale of loans originated for sale                                 | 4,418   | 1,078    |
| Stock compensation expense  | 164   | 154      |
| Increase in bank-owned life insurance, net  | (249 )  | (248 )   |
| Increase in accrued interest receivable   | (310 )  | (234 )   |
| (Increase) decrease in prepaid expenses and other assets                            | 1,265   | (271 )   |
| Increase in accrued interest payable  | 154   | 28       |
| Increase (decrease) in accrued expenses and other liabilities                       | 1,095   | (465 )   |
| Net cash provided by operating activities   | 6,717   | 3,304    |
| Cash flows from investing activities  |   |          |
| Loan originations and principal collections, net                                    | (43,771 )                                     | (8,071 ) |
| Purchase of residential mortgage loans  | —   | (6,911 ) |
| Proceeds from sales of loans held for sale previously classified as portfolio loans | 1,817   | 1,944    |
| Available for sale securities:  |   |          |
| Sales   | 18,195  | 6,118    |
| Maturities, repayments and calls  | 7,818   | 15,478   |
| Purchases   | (25,163 )                                     | (9,270 ) |
| Net cash (received) paid for acquisition  | 2,517   | (3,309 ) |
| Redemption (purchase) of federal bank stocks  | (34 )   | 1,364    |
| Proceeds from the sale of foreclosed real estate                                    | 144   | 215      |
| Purchases of premises and equipment   | (279 )  | (1,943 ) |
| Net cash used in investing activities   | (38,756 )                                     | (4,385 ) |
| Cash flows from financing activities  |   |          |
| Net increase in deposits  | 57,864  | 30,013   |

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|  |          |           |
|--|----------|-----------|
| Repayments on long-term debt                                 | (750 )   | (5,250 )  |
| Proceeds from other long-term debt                           | 5,000    | 5,000     |
| Net change in short-term borrowings                          | (7,000 ) | (11,750 ) |
| Proceeds from exercise of stock options                      | 1,376    | —         |
| Dividends paid   | (1,763 ) | (1,674 )  |
| Net cash provided by financing activities                    | 54,727   | 16,339    |
| <br>   |          |           |
| Increase in cash and cash equivalents                        | 22,688   | 15,258    |
| Cash and cash equivalents at beginning of period             | 17,568   | 11,546    |
| Cash and cash equivalents at end of period                   | \$40,256 | \$26,804  |
| <br>   |          |           |
| Supplemental information:                                    |          |           |
| Interest paid  | \$3,070  | \$2,881   |
| Income taxes paid  | 875      | 600       |
| <br>   |          |           |
| Supplemental noncash disclosure:                             |          |           |
| Transfers from loans to foreclosed real estate               | 272      | 218       |
| Transfers from portfolio loans to loans held for sale        | 1,725    | 1,859     |
| See accompanying notes to consolidated financial statements. |          |           |

## Emclaire Financial Corp

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

For the three and nine months ended September 30, 2017 and 2016

(Dollar amounts in thousands, except per share data)

|   | For the three<br>months ended<br>September 30,<br>2017 |          | For the nine months<br>ended September<br>30,<br>2016 |          |
|---|--|----------|---|----------|
| Balance at beginning of period            | \$56,647   | \$54,851 | \$54,073  | \$52,839 |
| Net income                                | 1,707  | 1,058    | 3,704   | 2,790    |
| Other comprehensive income (loss)         | 153  | (179)    | 525   | 1,107    |
| Stock compensation expense                | 55   | 44       | 164   | 154      |
| Dividends declared on common stock        | (596)  | (558)    | (1,763)   | (1,674)  |
| Exercise of stock options (53,586 shares) | 113  | —        | 1,376   | —        |
| Issuance of common stock (58,445 shares)  | 1,674  | —        | 1,674   | —        |
| Balance at end of period                  | \$59,753   | \$55,216 | \$59,753  | \$55,216 |
| Cash dividend per common share            | \$0.27   | \$0.26   | \$0.81  | \$0.78   |

See accompanying notes to consolidated financial statements.

Emclair Financial Corp  
Notes to Consolidated Financial Statements (Unaudited)

1. Nature of Operations and Basis of Presentation

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

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

The accompanying unaudited consolidated financial statements for the interim periods include all adjustments, consisting of normal recurring accruals, which are necessary, in the opinion of management, to fairly reflect the Corporation's consolidated financial position and results of operations. Additionally, these consolidated financial statements for the interim periods have been prepared in accordance with instructions for the Securities and Exchange Commission's (SEC's) Form 10-Q and Article 10 of Regulation S-X and therefore do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). For further information, refer to the audited consolidated financial statements and footnotes thereto for the year ended December 31, 2016, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016 filed with the SEC.

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

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

2. Mergers and Acquisitions

On September 30, 2017, the Corporation completed the acquisition of Northern Hancock Bank & Trust Co. (Northern Hancock) in accordance with the terms of the Agreement and Plan of Merger, dated as of May 4, 2017, in exchange for 54,445 shares of common stock valued at \$1.7 million and \$22,000 in cash. The acquisition expanded the Corporation's franchise into a new market and increased the Corporation's consolidated total assets, loans and deposits.

The assets and liabilities of Northern Hancock were recorded on the Corporation's consolidated balance sheet at their estimated fair value as of September 30, 2017.



## 2. Mergers and Acquisitions (continued)

The following table summarizes the estimated fair value of the assets acquired, liabilities assumed and consideration transferred in connection with the acquisition:

(Dollar amounts in thousands)

|  |         |
|--|---------|
| Assets acquired:                       |         |
| Cash and cash equivalents              | \$2,539 |
| Loans receivable                       | 18,480  |
| Federal bank stocks                    | 11      |
| Accrued interest receivable            | 103     |
| Premises and equipment                 | 708     |
| Core deposit intangible                | 167     |
| Prepaid expenses and other assets      | 757     |
| Total assets acquired                  | 22,765  |
| Liabilities assumed:                   |         |
| Deposits                               | 19,748  |
| Accrued interest payable               | 6       |
| Accrued expenses and other liabilities | 8       |
| Total liabilities assumed              | 19,762  |
| Identifiable net assets acquired       | 3,003   |
| Consideration paid:                    |         |
| Cash                                   | 22      |
| Common stock                           | 1,674   |
| Total consideration                    | 1,696   |
| Gain on bargain purchase               | \$1,307 |

In connection with the acquisition, the Corporation recognized approximately \$1.3 million of bargain purchase gain and a \$167,000 core deposit intangible. The core deposit intangible will be amortized over a weighted average estimated life of eight years using the double declining balance method. Core deposit intangible expense is expected to be \$11,000 for 2017 and is projected for the succeeding four years beginning 2018 to be \$40,000, \$30,000, \$22,000 and \$17,000 per year, respectively, and \$47,000 in total for years after 2021. The bargain purchase gain of \$1.3 million, recorded at the date of acquisition, represents the amount by which the acquisition-date fair value of the net identifiable assets acquired exceeded the fair value of the consideration transferred.

While the Corporation believes that the accounting for the acquisition is complete, the fair value of the acquired assets and liabilities noted in the table may change during the provisional period, which may last up to twelve months subsequent to the acquisition date. The Corporation may obtain additional information to refine the valuation of the acquired assets and liabilities and adjust the recorded fair value, although such adjustments are not expected to be significant.

The fair value of loans was estimated using discounted contractual cash flows. The book balance of the loans at the time of the acquisition was \$18.5 million before considering Northern Hancocks's allowance for loan losses, which

was not carried over. The fair value disclosed above reflects a credit-related adjustment of \$(566,000) and an adjustment for other factors of \$537,000. Loans evidencing credit deterioration since origination (purchased credit impaired loans) included in loans receivable were immaterial.



## 2. Mergers and Acquisitions (continued)

For the three months ended September 30, 2017, costs related to the acquisition totaled \$963,000 including system conversion costs, contract termination fees, legal fees, employee severance costs, accounting and auditing fees and other costs of \$344,000, \$279,000, \$108,000, \$108,000, \$46,000 and \$78,000, respectively. For the nine months ended September 30, 2017, costs related to the acquisition totaled \$1.1 million including system conversion costs, contract termination fees, legal fees, employee severance costs, accounting and auditing fees and other costs of \$344,000, \$279,000, \$200,000, \$108,000, \$55,000 and \$84,000, respectively. These costs were recognized in noninterest expense as incurred.

## 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<br>months ended<br>September 30,<br>2017 |           | For the nine<br>months ended<br>September 30,<br>2016 |           |
|---|--|-----------|---|-----------|
| Earnings per common share - basic   |  |           |   |           |
| Net income  | \$1,707  | \$ 1,058  | \$3,704   | \$ 2,790  |
| Average common shares outstanding   | 2,204,942  | 2,146,308 | 2,174,211   | 2,145,761 |
| Basic earnings per common share   | \$0.77   | \$ 0.49   | \$ 1.70   | \$ 1.30   |
| Earnings per common share - diluted   |  |           |   |           |
| Net income  | \$1,707  | \$ 1,058  | \$3,704   | \$ 2,790  |
| Average common shares outstanding   | 2,204,942  | 2,146,308 | 2,174,211   | 2,145,761 |
| Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options | 15,471   | 11,965    | 16,437  | 10,141    |
| Average shares and dilutive potential common shares   | 2,220,413  | 2,158,273 | 2,190,648   | 2,155,902 |
| Diluted earnings per common share   | \$0.77   | \$ 0.49   | \$ 1.69   | \$ 1.29   |
| Stock options not considered in computing earnings per share because they were antidilutive | —  | 57,000    | —   | 57,000    |



## 4. Securities

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

| (Dollar amounts in thousands)                                | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value   |
|--|----------------|------------------------|-------------------------|--------------|
| Available for sale:  |                |                        |                         |              |
| September 30, 2017:  |                |                        |                         |              |
| U.S. Treasury and federal agency                             | \$4,543        | \$ —                   | \$ (29)                 | ) \$4,514    |
| U.S. government sponsored entities and agencies              | 14,147         | 12                     | (119)                   | ) 14,040     |
| U.S. agency mortgage-backed securities: residential          | 21,615         | 45                     | (55)                    | ) 21,605     |
| U.S. agency collateralized mortgage obligations: residential | 23,516         | 36                     | (559)                   | ) 22,993     |
| State and political subdivisions                             | 26,621         | 140                    | (54)                    | ) 26,707     |
| Corporate debt securities                                    | 9,510          | 37                     | (18)                    | ) 9,529      |
| Equity securities  | 1,580          | 339                    | (6)                     | ) 1,913      |
|  | \$ 101,532     | \$ 609                 | \$ (840)                | ) \$ 101,301 |
| December 31, 2016:   |                |                        |                         |              |
| U.S. Treasury and federal agency                             | 4,550          | —                      | (50)                    | ) 4,500      |
| U.S. government sponsored entities and agencies              | 9,186          | —                      | (188)                   | ) 8,998      |
| U.S. agency mortgage-backed securities: residential          | 25,790         | 32                     | (196)                   | ) 25,626     |
| U.S. agency collateralized mortgage obligations: residential | 25,367         | 23                     | (684)                   | ) 24,706     |
| State and political subdivisions                             | 27,853         | 17                     | (262)                   | ) 27,608     |
| Corporate debt securities                                    | 8,012          | 5                      | (85)                    | ) 7,932      |
| Equity securities  | 1,829          | 373                    | (12)                    | ) 2,190      |
|  | \$ 102,587     | \$ 450                 | \$ (1,477)              | ) \$ 101,560 |

The following table summarizes scheduled maturities of the Corporation's debt securities as of September 30, 2017. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

| (Dollar amounts in thousands)                    | Available for sale |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
| Due in one year or less                          | \$2,852            | \$2,851    |
| Due after one year through five years            | 26,440             | 26,380     |
| Due after five through ten years                 | 11,860             | 11,899     |
| Due after ten years                              | 13,669             | 13,660     |
| Mortgage-backed securities: residential          | 21,615             | 21,605     |
| Collateralized mortgage obligations: residential | 23,516             | 22,993     |
|  | \$99,952           | \$99,388   |

## 4. Securities (continued)

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

| (Dollar amounts in thousands)                                | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| September 30, 2017:  |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency                             | \$4,514             | \$ (29 )        | \$—               | \$ —            | \$4,514    | \$ (29 )        |
| U.S. government sponsored entities and agencies              | 9,049               | (111 )          | 1,992             | (8 )            | 11,041     | (119 )          |
| U.S. agency mortgage-backed securities: residential          | 6,873               | (55 )           | —                 | —               | 6,873      | (55 )           |
| U.S. agency collateralized mortgage obligations: residential | 5,229               | (82 )           | 15,928            | (477 )          | 21,157     | (559 )          |
| State and political subdivisions                             | 5,098               | (39 )           | 1,646             | (15 )           | 6,744      | (54 )           |
| Corporate debt securities                                    | 2,986               | (18 )           | —                 | —               | 2,986      | (18 )           |
| Equity securities  | —                   | —               | 244               | (6 )            | 244        | (6 )            |
|  | \$33,749            | \$ (334 )       | \$19,810          | \$ (506 )       | \$53,559   | \$ (840 )       |
| December 31, 2016:   |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency                             | \$4,500             | \$ (50 )        | \$—               | \$ —            | \$4,500    | \$ (50 )        |
| U.S. government sponsored entities and agencies              | 8,998               | (188 )          | —                 | —               | 8,998      | (188 )          |
| U.S. agency mortgage-backed securities: residential          | 23,279              | (196 )          | —                 | —               | 23,279     | (196 )          |
| U.S. agency collateralized mortgage obligations: residential | 13,568              | (438 )          | 9,317             | (246 )          | 22,885     | (684 )          |
| State and political subdivisions                             | 21,924              | (262 )          | —                 | —               | 21,924     | (262 )          |
| Corporate debt securities                                    | 3,927               | (85 )           | —                 | —               | 3,927      | (85 )           |
| Equity securities  | —                   | —               | 237               | (12 )           | 237        | (12 )           |
|  | \$76,196            | \$ (1,219 )     | \$9,554           | \$ (258 )       | \$85,750   | \$ (1,477 )     |

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

| (Dollar amounts in thousands)  | For the three months ended September 30, |      | For the nine months ended September 30, |         |
|--------------------------------|--|------|---|---------|
|                                | 2017                                     | 2016 | 2017                                    | 2016    |
| Proceeds                       | \$ —                                     | \$ — | \$18,195                                | \$6,118 |
| Gains                          | —  | —    | 350                                     | 83      |
| Tax provision related to gains | —  | —    | 119                                     | 28      |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term

prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Corporation intends to sell an impaired security, or if it is more likely than not the Corporation will be required to sell the security before its anticipated recovery, the Corporation records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost. Otherwise, only the credit portion of the estimated loss on debt securities is recognized in earnings, with the other portion of the loss recognized in other comprehensive income. For equity securities determined to be other-than-temporarily impaired, the entire amount of impairment is recognized through earnings.

## 4. Securities (continued)

There was one equity security in an unrealized loss position for more than 12 months as of September 30, 2017. Equity securities owned by the Corporation consist of common stock of various financial service providers. This investment security is in an unrealized loss position as a result of the illiquid nature of the stock. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability, capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost in the near future. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell this security before the recovery of its amortized cost basis, the Corporation does not consider the equity security with an unrealized loss as of September 30, 2017 to be other-than-temporarily impaired.

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

After recognizing the aforementioned impairment, there were 69 debt securities in an unrealized loss position as of September 30, 2017, of which 24 were in an unrealized loss position for more than 12 months. Of these 69 securities, 25 were government-backed collateralized mortgage obligations, 17 were state and political subdivision securities, 10 were U.S. government sponsored entity and agency securities, 6 were corporate securities, 6 were mortgage-backed securities and 5 were U.S. Treasury securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider these debt securities with unrealized losses as of September 30, 2017 to be other-than-temporarily impaired.

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

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

| (Dollar amounts in thousands)         | September 30,<br>2017 | December 31,<br>2016 |
|---------------------------------------|-----------------------|----------------------|
| Mortgage loans on real estate:        |                       |                      |
| Residential first mortgages           | \$ 226,946            | \$ 198,167           |
| Home equity loans and lines of credit | 91,602                | 91,359               |
| Commercial real estate                | 192,123               | 166,994              |
|                                       | 510,671               | 456,520              |
| Other loans:                          |                       |                      |
| Commercial business                   | 60,394                | 57,788               |
| Consumer                              | 9,611                 | 6,672                |
|                                       | 70,005                | 64,460               |
| Total loans, gross                    | 580,676               | 520,980              |

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|                                |            |            |
|--------------------------------|------------|------------|
| Less allowance for loan losses | 5,940      | 5,545      |
| Total loans, net               | \$ 574,736 | \$ 515,435 |

During the nine months ended September 30, 2017, the Corporation sold \$1.1 million of residential mortgage loans and a \$590,000 commercial mortgage loan that were previously classified as held for investment.

Included in total loans above are net deferred costs of \$1.5 million and \$1.3 million at September 30, 2017 and December 31, 2016, respectively.

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

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 September 30, 2017, 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.



## 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<br>Mortgages | Home<br>Equity<br>& Lines<br>of Credit | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Total      |
|--|--------------------------|--|---------------------------|------------------------|----------|------------|
| Three months ended September 30, 2017:                 |                          |  |                           |                        |          |            |
| Allowance for loan losses:                             |                          |  |                           |                        |          |            |
| Beginning Balance                                      | \$ 1,994                 | \$ 639                                 | \$ 2,460                  | \$ 621                 | \$ 53    | \$ 5,767   |
| Charge-offs  | (2 )                     | (33 )                                  | (36 )                     | (4 )                   | (26 )    | (101 )     |
| Recoveries   | —                        | 1                                      | 2                         | —                      | 1        | 4          |
| Provision  | 46                       | 20                                     | 200                       | (21 )                  | 25       | 270        |
| Ending Balance   | \$ 2,038                 | \$ 627                                 | \$ 2,626                  | \$ 596                 | \$ 53    | \$ 5,940   |
| Nine months ended September 30, 2017:                  |                          |  |                           |                        |          |            |
| Allowance for loan losses:                             |                          |  |                           |                        |          |            |
| Beginning Balance                                      | \$ 1,846                 | \$ 633                                 | \$ 2,314                  | \$ 700                 | \$ 52    | \$ 5,545   |
| Charge-offs  | (38 )                    | (44 )                                  | (126 )                    | (14 )                  | (53 )    | (275 )     |
| Recoveries   | —                        | 21                                     | 6                         | —                      | 10       | 37         |
| Provision  | 230                      | 17                                     | 432                       | (90 )                  | 44       | 633        |
| Ending Balance   | \$ 2,038                 | \$ 627                                 | \$ 2,626                  | \$ 596                 | \$ 53    | \$ 5,940   |
| At September 30, 2017:                                 |                          |  |                           |                        |          |            |
| Ending ALL balance attributable to loans:              |                          |  |                           |                        |          |            |
| Individually evaluated for impairment                  | \$ 8                     | \$ —                                   | \$ —                      | \$ —                   | \$ —     | \$ 8       |
| Acquired loans collectively evaluated for impairment   | —                        | —                                      | —                         | —                      | —        | —          |
| Originated loans collectively evaluated for impairment | 2,030                    | 627                                    | 2,626                     | 596                    | 53       | 5,932      |
| Total  | \$ 2,038                 | \$ 627                                 | \$ 2,626                  | \$ 596                 | \$ 53    | \$ 5,940   |
| Total loans:   |                          |  |                           |                        |          |            |
| Individually evaluated for impairment                  | \$ 433                   | \$ —                                   | \$ 939                    | \$ 585                 | \$ —     | \$ 1,957   |
| Acquired loans collectively evaluated for impairment   | 28,792                   | 3,697                                  | 28,916                    | 2,390                  | 2,382    | 66,177     |
| Originated loans collectively evaluated for impairment | 197,721                  | 87,905                                 | 162,268                   | 57,419                 | 7,229    | 512,542    |
| Total  | \$ 226,946               | \$ 91,602                              | \$ 192,123                | \$ 60,394              | \$ 9,611 | \$ 580,676 |
| At December 31, 2016:                                  |                          |  |                           |                        |          |            |
| Ending ALL balance attributable to loans:              |                          |  |                           |                        |          |            |

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|  |            |           |            |           |          |            |
|--|------------|-----------|------------|-----------|----------|------------|
| Individually evaluated for impairment                  | \$ 19      | \$—       | \$ 95      | \$ 6      | \$—      | \$ 120     |
| Acquired loans collectively evaluated for impairment   | —          | —         | —          | —         | —        | —          |
| Originated loans collectively evaluated for impairment | 1,827      | 633       | 2,219      | 694       | 52       | 5,425      |
| Total  | \$ 1,846   | \$ 633    | \$ 2,314   | \$ 700    | \$ 52    | \$ 5,545   |
| Total loans:   |            |           |            |           |          |            |
| Individually evaluated for impairment                  | \$ 135     | \$—       | \$ 1,014   | \$ 684    | \$—      | \$ 1,833   |
| Acquired loans collectively evaluated for impairment   | 25,024     | 5,225     | 27,492     | 1,182     | 13       | 58,936     |
| Originated loans collectively evaluated for impairment | 173,008    | 86,134    | 138,488    | 55,922    | 6,659    | 460,211    |
| Total  | \$ 198,167 | \$ 91,359 | \$ 166,994 | \$ 57,788 | \$ 6,672 | \$ 520,980 |
| Three months ended September 30, 2016:                 |            |           |            |           |          |            |
| Allowance for loan losses:                             |            |           |            |           |          |            |
| Beginning Balance                                      | \$ 1,696   | \$ 645    | \$ 2,118   | \$ 920    | \$ 52    | \$ 5,431   |
| Charge-offs  | (22        | ) (19     | ) (11      | ) (11     | ) (31    | ) (94      |
| Recoveries   | —          | 1         | 2          | —         | 6        | 9          |
| Provision  | 58         | (1        | ) 10       | 75        | 26       | 168        |
| Ending Balance   | \$ 1,732   | \$ 626    | \$ 2,119   | \$ 984    | \$ 53    | \$ 5,514   |
| Nine months ended September 30, 2016:                  |            |           |            |           |          |            |
| Allowance for loan losses:                             |            |           |            |           |          |            |
| Beginning Balance                                      | \$ 1,429   | \$ 586    | \$ 2,185   | \$ 960    | \$ 45    | \$ 5,205   |
| Charge-offs  | (63        | ) (52     | ) (11      | ) (11     | ) (45    | ) (182     |
| Recoveries   | —          | 2         | 9          | —         | 10       | 21         |
| Provision  | 366        | 90        | (64        | ) 35      | 43       | 470        |
| Ending Balance   | \$ 1,732   | \$ 626    | \$ 2,119   | \$ 984    | \$ 53    | \$ 5,514   |

## 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 September 30, 2017:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance    |                        |                                   | For the three months ended                    |   |   |
|---------------------------------|---|------------------------|-----------------------------------|---|---|---|
|                                 | As of September 30, 2017                  |                        |                                   | September 30, 2017                            |   |   |
|                                 | Unpaid<br>Principal<br>Balance            | Recorded<br>Investment | Related<br>Allowance              | Average<br>Recorded<br>Investment             | Interest<br>Income<br>Recognized<br>in Period     | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$76                                      | \$ 76                  | \$ 8                              | \$76  | \$ —  | \$ —  |
| 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>\$ —</b>                                       | <b>\$ —</b>                                       |
|                                 |   |                        |                                   |   |   |   |
|                                 |   |                        |                                   | For the nine months ended                     |   |   |
|                                 |   |                        |                                   | September 30, 2017                            |   |   |
|                                 |   |                        |                                   | Average<br>Recorded<br>Investment             | Interest<br>Income<br>Recognized<br>in Period     | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     |   |                        |                                   | \$91  | \$ 2  | \$ 2  |
| Home equity and lines of credit |   |                        |                                   | —   | —   | —   |
| Commercial real estate          |   |                        |                                   | 139   | —   | —   |
| Commercial business             |   |                        |                                   | 147   | —   | —   |
| Consumer                        |   |                        |                                   | —   | —   | —   |
| <b>Total</b>                    |   |                        |                                   | <b>\$377</b>                                  | <b>\$ 2</b>                                       | <b>\$ 2</b>                                       |
|                                 |   |                        |                                   |   |   |   |
|                                 | Impaired Loans with No Specific Allowance |                        |                                   | For the three months ended                    |   |   |
|                                 | As of<br>September 30,<br>2017            |                        |                                   | September 30, 2017                            |   |   |
|                                 | Unpaid<br>Principal<br>Balance            | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |   |
| Residential first mortgages     | \$469                                     | \$ 357                 | \$362                             | \$ 1  | \$ 1  |   |
| Home equity and lines of credit | —   | —                      | —                                 | —   | —   |   |
| Commercial real estate          | 1,113                                     | 939                    | 957                               | 1   | 1   |   |
| Commercial business             | 585                                       | 585                    | 592                               | 1   | 1   |   |
| Consumer                        | —   | —                      | —                                 | —   | —   |   |



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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2016:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance    |                     |                             |                                      |  |  |
|---------------------------------|---|---------------------|-----------------------------|--------------------------------------|--|--|
|                                 | As of December 31, 2016                   |                     |                             | For the year ended December 31, 2016 |  |  |
|                                 | Unpaid Principal Balance                  | Recorded Investment | Related Allowance           | Average Recorded Investment          | Interest Income Recognized in Period     | Cash Basis Interest Recognized in Period |
| Residential first mortgages     | \$168                                     | \$ 135              | \$ 19                       | \$119                                | \$ 6                                     | \$ 6                                     |
| Home equity and lines of credit | —   | —                   | —                           | —                                    | —  | —  |
| Commercial real estate          | 557                                       | 557                 | 95                          | 130                                  | 23                                       | —  |
| Commercial business             | 588                                       | 588                 | 6                           | 428                                  | —  | —  |
| Consumer                        | —   | —                   | —                           | —                                    | —  | —  |
| <b>Total</b>                    | <b>\$1,313</b>                            | <b>\$ 1,280</b>     | <b>\$ 120</b>               | <b>\$677</b>                         | <b>\$ 29</b>                             | <b>\$ 6</b>                              |
|                                 | Impaired Loans with No Specific Allowance |                     |                             |                                      |  |  |
|                                 | As of December 31, 2016                   |                     |                             | For the year ended December 31, 2016 |  |  |
|                                 | Unpaid Principal Balance                  | Recorded Investment | Average Recorded Investment | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |  |
| Residential first mortgages     | \$—                                       | \$ —                | \$23                        | \$ —                                 | \$ —                                     |  |
| Home equity and lines of credit | —   | —                   | —                           | —                                    | —  |  |
| Commercial real estate          | 631                                       | 457                 | 735                         | 3                                    | 3  |  |
| Commercial business             | 96  | 96                  | 322                         | 2                                    | 2  |  |
| Consumer                        | —   | —                   | —                           | —                                    | —  |  |
| <b>Total</b>                    | <b>\$727</b>                              | <b>\$ 553</b>       | <b>\$1,080</b>              | <b>\$ 5</b>                          | <b>\$ 5</b>                              |  |

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

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

(Dollar amounts in thousands)

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

|                                 | Impaired Loans with Specific Allowance |                     |                   | For the nine months ended September 30, 2016 |                                      |  |
|---------------------------------|--|---------------------|-------------------|--|--------------------------------------|--|
|                                 | As of September 30, 2016               |                     |                   | Average Recorded Investment                  | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |
|                                 | Unpaid Principal Balance               | Recorded Investment | Related Allowance |  |                                      |  |
| Residential first mortgages     |  |                     |                   | \$ 115                                       | \$ 5                                 | \$ 5                                     |
| Home equity and lines of credit |  |                     |                   | —  | —                                    | —  |
| Commercial real estate          |  |                     |                   | 23   | —                                    | —  |
| Commercial business             |  |                     |                   | 388  | —                                    | —  |
| Consumer                        |  |                     |                   | —  | —                                    | —  |
| <b>Total</b>                    |  |                     |                   | <b>\$ 526</b>                                | <b>\$ 5</b>                          | <b>\$ 5</b>                              |

|                                 | Impaired Loans with No Specific Allowance |                     |                   | For the three months ended September 30, 2016 |                                      |  |
|---------------------------------|---|---------------------|-------------------|---|--------------------------------------|--|
|                                 | As of September 30, 2016                  |                     |                   | Average Recorded Investment                   | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |
|                                 | Unpaid Principal Balance                  | Recorded Investment | Related Allowance |   |                                      |  |
| Residential first mortgages     | \$ —                                      | \$ —                | \$ 29             | \$ —  | —                                    | \$ —                                     |
| Home equity and lines of credit | —   | —                   | —                 | —   | —                                    | —  |
| Commercial real estate          | 1,190                                     | 791                 | 807               | 1   | 1                                    | 1  |
| Commercial business             | 675                                       | 675                 | 682               | —   | —                                    | —  |
| Consumer                        | —   | —                   | —                 | —   | —                                    | —  |
| <b>Total</b>                    | <b>\$ 1,865</b>                           | <b>\$ 1,466</b>     | <b>\$ 1,518</b>   | <b>\$ 1</b>                                   | <b>\$ 1</b>                          | <b>\$ 1</b>                              |

|                                 | For the nine months ended<br>September 30, 2016 |  |   |
|---------------------------------|---|--|---|
|                                 | Average<br>Recorded<br>Investment               | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$29  | \$ —                                       | \$ —  |
| Home equity and lines of credit | —   | —  | —   |
| Commercial real estate          | 804   | 2  | 2   |
| Commercial business             | 379   | 1  | 1   |
| Consumer                        | —   | —  | —   |
| Total                           | \$1,212   | \$ 3                                       | \$ 3  |

## 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 September 30, 2017 and December 31, 2016, the Corporation had \$505,000 and \$239,000, respectively, of loans classified as TDRs, which are included in impaired loans above. The Corporation had allocated \$8,000 and \$19,000 of specific allowance for these loans at September 30, 2017 and December 31, 2016, respectively.

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

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

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

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

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



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

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

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

Management uses the following definitions for risk ratings:

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

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

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

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

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

(Dollar amounts in thousands)

|                                 | Not<br>Rated     | Pass             | Special<br>Mention | Substandard      | Doubtful  | Total             |
|---------------------------------|------------------|------------------|--------------------|------------------|-----------|-------------------|
| September 30, 2017:             |                  |                  |                    |                  |           |                   |
| Residential first mortgages     | \$224,759        | \$—              | \$—                | \$ 2,187         | \$        | —\$226,946        |
| Home equity and lines of credit | 91,172           | —                | —                  | 430              | —         | 91,602            |
| Commercial real estate          | —                | 181,561          | 3,049              | 7,513            | —         | 192,123           |
| Commercial business             | —                | 58,487           | 546                | 1,361            | —         | 60,394            |
| Consumer                        | 9,525            | —                | —                  | 86               | —         | 9,611             |
| <b>Total</b>                    | <b>\$325,456</b> | <b>\$240,048</b> | <b>\$ 3,595</b>    | <b>\$ 11,577</b> | <b>\$</b> | <b>—\$580,676</b> |
| December 31, 2016:              |                  |                  |                    |                  |           |                   |
| Residential first mortgages     | \$197,041        | \$—              | \$—                | \$ 1,126         | \$        | —\$198,167        |
| Home equity and lines of credit | 91,017           | —                | —                  | 342              | —         | 91,359            |
| Commercial real estate          | —                | 161,312          | 1,077              | 4,605            | —         | 166,994           |
| Commercial business             | —                | 52,125           | 4,926              | 737              | —         | 57,788            |
| Consumer                        | 6,659            | —                | —                  | 13               | —         | 6,672             |
| <b>Total</b>                    | <b>\$294,717</b> | <b>\$213,437</b> | <b>\$ 6,003</b>    | <b>\$ 6,823</b>  | <b>\$</b> | <b>—\$520,980</b> |



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

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of September 30, 2017 and December 31, 2016:

(Dollar amounts in thousands)

|                                 | Performing                           |                                       |                                       | Nonperforming                          |                 | Total            |
|---------------------------------|--------------------------------------|---------------------------------------|---------------------------------------|--|-----------------|------------------|
|                                 | Accruing<br>Loans<br>Not<br>Past Due | Accruing<br>30-59<br>Days<br>Past Due | Accruing<br>60-89<br>Days<br>Past Due | Accruing<br>90+<br>Days<br>Past<br>Due | Nonaccrual      |                  |
| September 30, 2017:             |                                      |                                       |                                       |  |                 |                  |
| Residential first mortgages     | \$221,942                            | \$ 2,400                              | \$ 833                                | \$ 900                                 | \$ 871          | \$226,946        |
| Home equity and lines of credit | 90,502                               | 394                                   | 281                                   | —                                      | 425             | 91,602           |
| Commercial real estate          | 190,031                              | 693                                   | 449                                   | —                                      | 950             | 192,123          |
| Commercial business             | 59,509                               | 209                                   | 91                                    | —                                      | 585             | 60,394           |
| Consumer                        | 9,201                                | 262                                   | 148                                   | —                                      | —               | 9,611            |
| <b>Total loans</b>              | <b>\$571,185</b>                     | <b>\$ 3,958</b>                       | <b>\$ 1,802</b>                       | <b>\$ 900</b>                          | <b>\$ 2,831</b> | <b>\$580,676</b> |
| December 31, 2016:              |                                      |                                       |                                       |  |                 |                  |
| Residential first mortgages     | \$194,830                            | \$ 1,916                              | \$ 295                                | \$ —                                   | \$ 1,126        | \$198,167        |
| Home equity and lines of credit | 90,557                               | 460                                   | —                                     | 2                                      | 340             | 91,359           |
| Commercial real estate          | 165,318                              | 561                                   | —                                     | 42                                     | 1,073           | 166,994          |
| Commercial business             | 56,972                               | 56                                    | 34                                    | —                                      | 726             | 57,788           |
| Consumer                        | 6,602                                | 28                                    | 29                                    | —                                      | 13              | 6,672            |
| <b>Total loans</b>              | <b>\$514,279</b>                     | <b>\$ 3,021</b>                       | <b>\$ 358</b>                         | <b>\$ 44</b>                           | <b>\$ 3,278</b> | <b>\$520,980</b> |

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

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

(Dollar amounts in thousands)

|                                 | Not<br>Past<br>Due | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90<br>Days +<br>Past<br>Due | Total          |
|---------------------------------|--------------------|------------------------------|------------------------------|-----------------------------|----------------|
| September 30, 2017:             |                    |                              |                              |                             |                |
| Residential first mortgages     | \$373              | \$ 76                        | \$ —                         | \$422                       | \$871          |
| Home equity and lines of credit | —                  | —                            | —                            | 425                         | 425            |
| Commercial real estate          | 355                | —                            | —                            | 595                         | 950            |
| Commercial business             | 585                | —                            | —                            | —                           | 585            |
| Consumer                        | —                  | —                            | —                            | —                           | —              |
| <b>Total loans</b>              | <b>\$1,313</b>     | <b>\$ 76</b>                 | <b>\$ —</b>                  | <b>\$1,442</b>              | <b>\$2,831</b> |
| December 31, 2016:              |                    |                              |                              |                             |                |
| Residential first mortgages     | 72                 | 77                           | —                            | 977                         | 1,126          |
| Home equity and lines of credit | —                  | —                            | —                            | 340                         | 340            |
| Commercial real estate          | 397                | —                            | 557                          | 119                         | 1,073          |
| Commercial business             | 631                | —                            | —                            | 95                          | 726            |
| Consumer                        | —                  | —                            | —                            | 13                          | 13             |
| <b>Total loans</b>              | <b>\$1,100</b>     | <b>\$ 77</b>                 | <b>\$ 557</b>                | <b>\$1,544</b>              | <b>\$3,278</b> |

## 6. Goodwill and Intangible Assets

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

|                          | September 30, 2017          |                             | December 31, 2016           |                             |
|--------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                          | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| Goodwill                 | \$10,288                    | \$ —                        | \$10,288                    | \$ —                        |
| Core deposit intangibles | 4,426                       | 3,876                       | 4,259                       | 3,699                       |
| <b>Total</b>             | <b>\$14,714</b>             | <b>\$ 3,876</b>             | <b>\$14,547</b>             | <b>\$ 3,699</b>             |

Goodwill resulted from four acquisitions. During 2016, the Corporation recorded \$6.6 million of goodwill related to the acquisition of United American Savings Bank. Goodwill represents the excess of the total purchase price paid for the acquisitions over the fair value of the identifiable assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. The Corporation has selected November 30 as the date to perform the annual

impairment test. No goodwill impairment charges were recorded during 2016 or in the first nine months of 2017.

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 nine month periods ending September 30, 2017, the Corporation recorded intangible amortization expense totaling \$58,000 and \$177,000, respectively, compared to \$60,000 and \$165,000, respectively for the same periods in 2016.

## 7. Stock Compensation Plan

In April 2014, the Corporation adopted the 2014 Stock Incentive Plan (the 2014 Plan), which is shareholder approved and permits the grant of restricted stock awards and options to its directors, officers and employees for up to 176,866 shares of common stock. As of September 30, 2017, 65,783 shares of restricted stock and 88,433 stock options remain available for issuance under the plan.

In addition, the Corporation's 2007 Stock Incentive Plan and Trust (the 2007 Plan), which is shareholder approved, permitted the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock. As of September 30, 2017, no additional shares of stock may be issued as the plan expired on June 20, 2017.

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

A summary of option activity under the Plans as of September 30, 2017, and changes during the period then ended is presented below:

|                                      | Options  | Weighted-Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) | Weighted-Average<br>Remaining Term<br>(in years) |
|--------------------------------------|----------|------------------------------------|--|--|
| Outstanding as of January 1, 2017    | 62,000   | \$ 25.71                           | \$ 219   | 0.6  |
| Granted                              | —        | —                                  | —  | —  |
| Exercised                            | (53,586) | 25.67                              | 108  | —  |
| Forfeited                            | —        | —                                  | —  | —  |
| Expired                              | (8,414 ) | 26.00                              | —  | —  |
| Outstanding as of September 30, 2017 | —        | \$ —                               | \$ —   | —  |
| Exercisable as of September 30, 2017 | —        | \$ —                               | \$ —   | —  |

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

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

For the three and nine month periods ended September 30, 2017, the Corporation recognized stock compensation expense of \$55,000 and \$164,000, respectively, compared to \$44,000 and \$154,000, respectively, for the same periods in 2016. As of September 30, 2017, there was \$315,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 1.30 years. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.



## 8. Fair Value

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

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

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

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

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

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

The Corporation used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

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

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

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



## 8. Fair Value (continued)

Impaired loans – At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of September 30, 2017, the Corporation did not have any impaired loans carried at fair value measured using the fair value of collateral, compared to loan balances of \$1.2 million, net of a valuation allowance of \$120,000, at December 31, 2016. There was no additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2017 and 2016.

Other real estate owned (OREO) – Assets acquired through or instead of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Management's ongoing review of appraisal information may result in additional discounts or adjustments to the valuation based upon more recent market sales activity or more current appraisal information derived from properties of similar type and/or locale. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. As of September 30, 2017 and December 31, 2016, the Corporation had no OREO measured at fair value. There was no expense recorded during the three and nine month periods ended September 30, 2017 and 2016 associated with the write-down of OREO.

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

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

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

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

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

## 8. Fair Value (continued)

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

| Description  | Total     | (Level 1)  | (Level 2)                                    | (Level 3)                             |
|--|-----------|--|--|---------------------------------------|
|  |           | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
| September 30, 2017:  |           |  |  |                                       |
| U.S. Treasury and federal agency                             | \$4,514   | \$ 4,514   | \$ —   | \$ —                                  |
| U.S. government sponsored entities and agencies              | 14,040    | —  | 14,040                                       | —                                     |
| U.S. agency mortgage-backed securities: residential          | 21,605    | —  | 21,605                                       | —                                     |
| U.S. agency collateralized mortgage obligations: residential | 22,993    | —  | 22,993                                       | —                                     |
| State and political subdivision                              | 26,707    | —  | 26,707                                       | —                                     |
| Corporate debt securities                                    | 9,529     | —  | 9,529  | —                                     |
| Equity securities  | 1,913     | 1,779  | —  | 134                                   |
|  | \$101,301 | \$ 6,293   | \$ 94,874                                    | \$ 134                                |
| December 31, 2016:   |           |  |  |                                       |
| U.S. Treasury and federal agency                             | 4,500     | 4,500  | —  | —                                     |
| U.S. government sponsored entities and agencies              | 8,998     | —  | 8,998  | —                                     |
| U.S. agency mortgage-backed securities: residential          | 25,626    | —  | 25,626                                       | —                                     |
| U.S. agency collateralized mortgage obligations: residential | 24,706    | —  | 24,706                                       | —                                     |
| State and political subdivisions                             | 27,608    | —  | 27,608                                       | —                                     |
| Corporate debt securities                                    | 7,932     | —  | 7,932  | —                                     |
| Equity securities  | 2,190     | 2,054  | —  | 136                                   |
|  | \$101,560 | \$ 6,554   | \$ 94,870                                    | \$ 136                                |

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and nine month periods ended September 30, 2017 and 2016, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the three and nine month periods ended September 30, 2017 and 2016:

| (Dollar amounts in thousands)                | Three months ended |                    | Nine months ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2017 | September 30, 2016 | September 30, 2017 | September 30, 2016 |
| Balance at the beginning of the period       | \$ 135             | \$ 135             | \$ 136             | \$ 74              |
| Total gains or losses (realized/unrealized): |                    |                    |                    |                    |
| Included in earnings                         | —                  | —                  | —                  | —                  |

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|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Included in other comprehensive income | (1 )  | —     | (2 )  | 1     |
| Acquired                               | —     | —     | —     | 60    |
| Transfers in and/or out of Level 3     | —     | —     | —     | —     |
| Balance at the end of the period       | \$134 | \$135 | \$134 | \$135 |

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## 8. Fair Value (continued)

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

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

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

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

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

## 8. Fair Value (continued)

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of September 30, 2017 and December 31, 2016:

(Dollar amounts in thousands)

| Description                   | Carrying Amount | Fair Value Measurements using: |           |           |           |
|-------------------------------|-----------------|--------------------------------|-----------|-----------|-----------|
|                               |                 | Total                          | Level 1   | Level 2   | Level 3   |
| September 30, 2017:           |                 |                                |           |           |           |
| Financial Assets:             |                 |                                |           |           |           |
| Cash and cash equivalents     | \$40,256        | \$40,256                       | \$40,256  | \$—       | \$—       |
| Securities available for sale | 101,301         | 101,301                        | 6,293     | 94,874    | 134       |
| Loans, net                    | 574,736         | 576,705                        | —         | —         | 576,705   |
| Federal bank stock            | 4,906           | —                              | N/A       | N/A       | N/A       |
| Accrued interest receivable   | 2,228           | 2,228                          | 86        | 405       | 1,737     |
|                               | \$723,427       | \$720,490                      | \$46,635  | \$95,279  | \$578,576 |
| Financial Liabilities:        |                 |                                |           |           |           |
| Deposits                      | 662,552         | 664,374                        | 489,904   | 174,470   | —         |
| Borrowed funds                | 41,250          | 41,043                         | —         | 41,043    | —         |
| Accrued interest payable      | 399             | 399                            | 17        | 382       | —         |
|                               | \$704,201       | \$705,816                      | \$489,921 | \$215,895 | \$—       |

| Description                   | Carrying Amount | Fair Value Measurements using: |           |           |           |
|-------------------------------|-----------------|--------------------------------|-----------|-----------|-----------|
|                               |                 | Total                          | Level 1   | Level 2   | Level 3   |
| December 31, 2016:            |                 |                                |           |           |           |
| Financial Assets:             |                 |                                |           |           |           |
| Cash and cash equivalents     | \$17,568        | \$17,568                       | \$17,568  | \$—       | \$—       |
| Securities available for sale | 101,560         | 101,560                        | 6,554     | 94,870    | 136       |
| Loans held for sale           | 68              | 68                             | —         | 68        | —         |
| Loans, net                    | 515,435         | 519,573                        | —         | —         | 519,573   |
| Federal bank stock            | 4,861           | —                              | N/A       | N/A       | N/A       |
| Accrued interest receivable   | 1,815           | 1,815                          | 37        | 365       | 1,413     |
|                               | \$641,307       | \$640,584                      | \$24,159  | \$95,303  | \$521,122 |
| Financial Liabilities:        |                 |                                |           |           |           |
| Deposits                      | 584,940         | 582,458                        | 423,693   | 158,765   | —         |
| Borrowed funds                | 44,000          | 44,027                         | —         | 44,027    | —         |
| Accrued interest payable      | 239             | 239                            | 7         | 232       | —         |
|                               | \$629,179       | \$626,724                      | \$423,700 | \$203,024 | \$—       |

## 9. Regulatory Matters

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





## 9. Regulatory Matters (continued)

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

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

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

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

| (Dollar amounts in thousands)                         | September 30,<br>2017 |        | December 31,<br>2016 |        |
|---|-----------------------|--------|----------------------|--------|
|   | Amount                | Ratio  | Amount               | Ratio  |
| Total capital to risk-weighted assets:                |                       |        |                      |        |
| Actual  | \$63,229              | 12.39% | \$58,605             | 12.69% |
| For capital adequacy purposes                         | 40,818                | 8.00 % | 36,945               | 8.00 % |
| To be well capitalized                                | 51,022                | 10.00% | 46,181               | 10.00% |
| Tier 1 capital to risk-weighted assets:               |                       |        |                      |        |
| Actual  | \$57,282              | 11.23% | \$53,050             | 11.49% |
| For capital adequacy purposes                         | 30,613                | 6.00 % | 27,709               | 6.00 % |
| To be well capitalized                                | 40,818                | 8.00 % | 36,945               | 8.00 % |
| Common Equity Tier 1 capital to risk-weighted assets: |                       |        |                      |        |
| Actual  | \$57,282              | 11.23% | \$53,050             | 11.49% |
| For capital adequacy purposes                         | 22,960                | 4.50 % | 20,781               | 4.50 % |
| To be well capitalized                                | 33,165                | 6.50 % | 30,018               | 6.50 % |
| Tier 1 capital to average assets:                     |                       |        |                      |        |
| Actual  | \$57,282              | 7.82 % | \$53,050             | 7.84 % |
| For capital adequacy purposes                         | 29,307                | 4.00 % | 27,081               | 4.00 % |
| To be well capitalized                                | 36,634                | 5.00 % | 33,852               | 5.00 % |



10. Accumulated Other Comprehensive Income (Loss)

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the three months ended September 30, 2017 and 2016 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)   | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|---|---|--|-----------|
| Accumulated Other Comprehensive Income (Loss) at July 1, 2017           | \$ (307 )   | \$(3,812)                              | \$(4,119) |
| Other comprehensive income before reclassification                      | 153   | —                                      | 153       |
| Amounts reclassified from accumulated other comprehensive income (loss) | —   | —                                      | —         |
| Net current period other comprehensive income                           | 153   | —                                      | 153       |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2017     | \$ (154 )   | \$(3,812)                              | \$(3,966) |

(Dollar amounts in thousands)

| Details about Accumulated Other<br>Comprehensive Loss Components | Amount<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income<br>For the three<br>months<br>ended<br>September 30,<br>2017 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--|--|---|
| Unrealized gains and losses on available-for-sale securities     | \$ —   | Net gain on sale of available-for-sale securities                       |
| Unrealized gains and losses on available-for-sale securities     | —  | Other than temporary impairment losses                                  |
|  | —  | Provision for income taxes  |
| Total reclassifications for the period                           | \$ —   | Net of tax  |

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

Accumulated Other Comprehensive Income (Loss) at September 30, 2016    \$ 859                      \$(3,514) \$(2,655)

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

(Dollar amounts in thousands)

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

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the nine months ended September 30, 2017 and 2016 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)   | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|---|---|--|-----------|
| Accumulated Other Comprehensive Income (Loss) at January 1, 2017        | \$ (679 )   | \$(3,812)                              | \$(4,491) |
| Other comprehensive income before reclassification                      | 421   | —                                      | 421       |
| Amounts reclassified from accumulated other comprehensive income (loss) | 104   | —                                      | 104       |
| Net current period other comprehensive income                           | 525   | —                                      | 525       |
| Accumulated Other Comprehensive Income (Loss) at September 30, 2017     | \$ (154 )   | \$(3,812)                              | \$(3,966) |

(Dollar amounts in thousands)

| Details about Accumulated Other Comprehensive Loss Components | Amount<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income<br>For the nine<br>months<br>ended | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|---|--|---|
|---|--|---|

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|  | September 30,<br>2017 |   |
|--|-----------------------|---|
| 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                                      |

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

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

(Dollar amounts in thousands)

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

## 11. Recent Accounting Pronouncements

## Newly Issued Not Yet Effective Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-9 “Revenue from Contracts with Customers”. ASU 2014-9 provides guidance that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of this standard to annual and interim periods beginning after December 15, 2017; however, early adoption is permitted for annual and interim reporting periods beginning after December 15, 2016. ASU 2014-9 is not expected to have a significant impact on the Corporation's interest income, as our financial instruments are not within the scope of this standard, or fee-based income. We will continue to evaluate the impact of this standard and we do not anticipate this will 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 is effective for interim and annual periods beginning after December 15, 2017. ASU 2016-1 is not expected to have a significant impact on the Corporation's financial statements.

## 11. Recent Accounting Pronouncements (continued)

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

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

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

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

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

## 11. Recent Accounting Pronouncements (continued)

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

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

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

This section discusses the consolidated financial condition and results of operations of Emclaire Financial Corp and its wholly owned subsidiaries for the nine months ended September 30, 2017, compared to the same period in 2016 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 32 of this Form 10-Q.

This Form 10-Q, including the financial statements and related notes, contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, objectives, expected operating results and the assumptions upon which those statements are based. Forward looking statements include without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and are typically identified with words such as "may,"

“could,” “should,” “will,” “would,” “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan” or words or phrases of similar meaning. We caution that the forward looking statements are based largely on our expectations and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are, in many instances, beyond our control. Actual results, performances or achievements could differ materially from those contemplated, expressed or implied by the forward looking statements. Therefore, we caution you not to place undue reliance on our forward looking information and statements. Except as required by applicable law or regulation, we will not update the forward looking statements to reflect actual results or changes in factors affecting the forward looking statements.

## CHANGES IN FINANCIAL CONDITION

Total assets increased \$81.8 million, or 11.8%, to \$773.9 million at September 30, 2017 from \$692.1 million at December 31, 2016. Asset growth was driven by increases in net loans receivable and cash and equivalents of \$59.3 million and \$22.7 million, respectively. Loan growth was the result of strong production in the Bank's retail and commercial channels and the addition of \$18.5 million in loans through the acquisition of Northern Hancock Bank & Trust Co. (Northern Hancock), with residential mortgages and commercial mortgages increasing by \$28.8 million and \$25.1 million, respectively. Total liabilities increased \$76.1 million, or 11.9%, to \$714.2 million at September 30, 2017 from \$638.1 million at December 31, 2016, resulting primarily from a \$77.6 million, or 13.3%, increase in customer deposits. Deposit growth consisted of a \$71.5 million, or 15.5%, increase in interest bearing deposits and a \$6.2 million, or 5.0%, increase in noninterest-bearing deposits. Deposits added through the acquisition of Northern Hancock totaled \$19.7 million.

Stockholders' equity increased \$5.7 million, or 10.5%, to \$59.8 million at September 30, 2017 from \$54.1 million at December 31, 2016 primarily due to \$1.7 million of common stock issued in connection with the acquisition of Northern Hancock, proceeds from the exercise of stock options of \$1.4 million and net income of \$3.7 million for the nine month period, offset by common stock dividends paid of \$1.8 million. Book value per common share was \$26.39 at September 30, 2017, compared to \$25.12 at December 31, 2016.

At September 30, 2017, the Bank was considered "well-capitalized" with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.82%, 11.23%, 11.23% and 12.39%, respectively. The Bank was also considered "well-capitalized" at December 31, 2016 with a Tier 1 leverage ratio, Common Equity Tier 1 ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 7.84%, 11.49%, 11.49% and 12.69%, respectively.

## RESULTS OF OPERATIONS

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

General. Net income increased \$649,000, or 61.3%, to \$1.7 million for the three months ended September 30, 2017 from \$1.1 million for the same period in 2016. This increase was the result of increases in noninterest income and net interest income of \$1.3 million and \$532,000, respectively, partially offset by increases in noninterest expense, the provision for loans losses and the provision for income taxes of \$948,000, \$102,000 and \$95,000, respectively.

Net interest income. Tax equivalent net interest income increased \$519,000, or 10.1%, to \$5.7 million for the three months ended September 30, 2017 from \$5.2 million for the three months ended September 30, 2016. This increase was attributed to an increase in tax equivalent interest income of \$576,000, partially offset by an increase in interest expense of \$57,000.

Interest income. Tax equivalent interest income increased \$576,000, or 9.2%, to \$6.8 million for the three months ended September 30, 2017 from \$6.2 million for the same period in 2016. This increase was attributed to increases in interest earned on loans and interest-earning deposits with banks and dividends on federal bank stocks of \$519,000, \$50,000 and \$15,000, respectively, partially offset by a decrease in interest earned on securities of \$8,000.

Tax equivalent interest earned on loans receivable increased \$519,000, or 9.4%, to \$6.1 million for the three months ended September 30, 2017 compared to \$5.5 million for the same period in 2016. This increase resulted from a \$50.4 million, or 10.0% increase in average loans, accounting for an increase of \$548,000 in interest income. The increase in loans receivable was related to the acquisition of United American in April 2016 and strong loan growth achieved in

late 2016 and the first nine months of 2017. Partially offsetting this favorable volume variance, the average yield on loans decreased 4 basis points to 4.31% for the three months ended September 30, 2017, versus 4.35% for the same period in 2016. This unfavorable yield variance accounted for a \$29,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$8,000, or 1.3%, to \$604,000 for the three months ended September 30, 2017 compared to \$612,000 for the three months ended September 30, 2016. This decrease resulted from a \$2.5 million, or 2.4%, decrease in the average balance of securities, accounting for a \$15,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 2 basis points to 2.36% for the three months ended September 30, 2017 versus 2.34% for the same period in 2016. This favorable yield variance accounted for a \$7,000 increase in interest income.

Interest earned on deposits with banks increased \$50,000 to \$98,000 for the three months ended September 30, 2017 compared to \$48,000 for the three months ended September 30, 2016. This increase resulted from a 63 basis point increase in the average yield on these accounts to 1.16% for the three months ended September 30, 2017, versus 0.53% for the same period in 2016, accounting for a \$54,000 increase in interest income. Partially offsetting the favorable yield variance, the average balance of interest-earning deposits decreased \$2.7 million, or 7.4%, accounting for a decrease of \$4,000 in interest income.

Dividends on federal bank stocks increased \$15,000, or 30.6%, to \$64,000 for the three months ended September 30, 2017 from \$49,000 for the same period in 2016. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.1 million, or 28.8%, to \$4.9 million compared to \$3.8 million for the same period in 2016, accounting for a \$14,000 increase in interest income. Additionally, the average yield on these assets increased 6 basis points to 5.20% for the three months ended September 30, 2017, versus 5.14% for the same period in 2016, accounting for a \$1,000 increase in interest income.

Interest expense. Interest expense increased \$57,000, or 5.3%, to \$1.15 million for the three months ended September 30, 2017 from \$1.09 million for the same period in 2016. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$43,000 and \$14,000, respectively.

Interest expense incurred on deposits increased \$43,000, or 5.5%, to \$824,000 for the three months ended September 30, 2017 compared to \$781,000 for the same period in 2016. The average balance of interest-bearing deposits increased \$37.0 million, or 7.9%, to \$507.6 million for the three months ended September 30, 2017, compared to \$470.7 million for the same period in 2016 causing a \$60,000 increase in interest expense. This increase was primarily due to the acquisition of United American in April 2016 and strong deposit growth during the first nine months of 2017. Partially offsetting the volume variance, the average cost of interest-bearing deposits decreased 2 basis points to 0.64% for the three months ended September 30, 2017, versus 0.66% for the same period in 2016, accounting for a \$17,000 reduction in interest expense.

Interest expense incurred on borrowed funds increased \$14,000, or 4.5%, to \$322,000 for the three months ended September 30, 2017, compared to \$308,000 for the same period in the prior year. The average balance of borrowed funds increased \$4.0 million, or 10.8%, to \$41.3 million for the three months ended September 30, 2017, compared to \$37.3 million for the same period in 2016 causing a \$31,000 increase in interest expense. Partially offsetting the volume variance, the average cost of long term borrowed funds decreased 21 basis points to 3.01% for the three months ended September 30, 2017 compared to 3.22% for the same period in 2016 causing an \$18,000 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 September 30, |          |            |                 |          |            |
|---|----------------------------------|----------|------------|-----------------|----------|------------|
|   | 2017                             |          |            | 2016            |          |            |
|   | Average Balance                  | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| Interest-earning assets:                |                                  |          |            |                 |          |            |
| Loans, taxable                          | \$532,225                        | \$5,763  | 4.30 %     | \$480,450       | \$5,232  | 4.33 %     |
| Loans, tax exempt                       | 24,495                           | 289      | 4.69 %     | 25,887          | 301      | 4.63 %     |
| Total loans receivable                  | 556,720                          | 6,052    | 4.31 %     | 506,337         | 5,533    | 4.35 %     |
| Securities, taxable                     | 75,367                           | 421      | 2.22 %     | 75,493          | 396      | 2.09 %     |
| Securities, tax exempt                  | 26,100                           | 183      | 2.78 %     | 28,518          | 216      | 3.01 %     |
| Total securities                        | 101,467                          | 604      | 2.36 %     | 104,011         | 612      | 2.34 %     |
| Interest-earning deposits with banks    | 33,512                           | 98       | 1.16 %     | 36,203          | 48       | 0.53 %     |
| Federal bank stocks                     | 4,882                            | 64       | 5.20 %     | 3,789           | 49       | 5.14 %     |
| Total interest-earning cash equivalents | 38,394                           | 162      | 1.67 %     | 39,992          | 97       | 0.96 %     |
| Total interest-earning assets           | 696,581                          | 6,818    | 3.88 %     | 650,340         | 6,242    | 3.82 %     |
| Cash and due from banks                 | 2,720                            |          |            | 2,730           |          |            |
| Other noninterest-earning assets        | 45,308                           |          |            | 44,840          |          |            |
| Total Assets                            | \$744,609                        |          |            | \$697,910       |          |            |
| Interest-bearing liabilities:           |                                  |          |            |                 |          |            |
| Interest-bearing demand deposits        | \$340,771                        | \$314    | 0.37 %     | \$298,031       | \$157    | 0.21 %     |
| Time deposits                           | 166,872                          | 510      | 1.21 %     | 172,627         | 624      | 1.44 %     |
| Total interest-bearing deposits         | 507,643                          | 824      | 0.64 %     | 470,658         | 781      | 0.66 %     |
| Borrowed funds, short-term              | 2,500                            | 28       | 4.50 %     | 2,500           | 27       | 4.28 %     |
| Borrowed funds, long-term               | 38,766                           | 294      | 3.01 %     | 34,750          | 281      | 3.22 %     |
| Total borrowed funds                    | 41,266                           | 322      | 3.10 %     | 37,250          | 308      | 3.29 %     |
| Total interest-bearing liabilities      | 548,909                          | 1,146    | 0.83 %     | 507,908         | 1,089    | 0.85 %     |
| Noninterest-bearing demand deposits     | 128,254                          | —        | —          | 125,965         | —        | —          |
| Funding and cost of funds               | 677,163                          | 1,146    | 0.67 %     | 633,873         | 1,089    | 0.68 %     |
| Other noninterest-bearing liabilities   | 10,061                           |          |            | 8,929           |          |            |

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|   |           |           |
|---|-----------|-----------|
| Total Liabilities   | 687,224   | 642,802   |
| Stockholders' Equity  | 57,385    | 55,108    |
| Total Liabilities and Stockholders' Equity  | \$744,609 | \$697,910 |
| Net interest income   | \$5,672   | \$5,153   |
| Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) | 3.05 %    | 2.97 %    |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                | 3.23 %    | 3.15 %    |

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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<br>September 30,<br>2017 versus 2016<br>Increase (Decrease)<br>due to |        |       |
|--------------------------------------|--|--------|-------|
|                                      | Volume   | Rate   | Total |
| Interest income:                     |  |        |       |
| Loans                                | \$548  | \$(29) | \$519 |
| Securities                           | (15)   | 7      | (8)   |
| Interest-earning deposits with banks | (4)  | 54     | 50    |
| Federal bank stocks                  | 14   | 1      | 15    |
| Total interest-earning assets        | 543  | 33     | 576   |
| Interest expense:                    |  |        |       |
| Interest-bearing deposits            | 60   | (17)   | 43    |
| Borrowed funds, short-term           | —  | 1      | 1     |
| Borrowed funds, long-term            | 31   | (18)   | 13    |
| Total interest-bearing liabilities   | 91   | (34)   | 57    |
| Net interest income                  | \$452  | \$67   | \$519 |

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

Information pertaining to the allowance for loan losses and nonperforming assets for the three months ended September 30, 2017 and 2016 is as follows:

| (Dollar amounts in thousands)                    | As of or for the<br>three months ended |          |
|--|--|----------|
|  | September 30,<br>2017                  | 2016     |
| Balance at the beginning of the period           | \$5,767                                | \$5,431  |
| Provision for loan losses                        | 270                                    | 168      |
| Charge-offs                                      | (101 )                                 | (94 )    |
| Recoveries                                       | 4                                      | 9        |
| Balance at the end of the period                 | \$5,940                                | \$5,514  |
| Nonperforming loans                              | \$3,731                                | \$3,327  |
| Nonperforming assets                             | 4,160                                  | 3,508    |
| Nonperforming loans to total loans               | 0.64 %                                 | 0.65 %   |
| Nonperforming assets to total assets             | 0.54 %                                 | 0.51 %   |
| Allowance for loan losses to total loans         | 1.02 %                                 | 1.07 %   |
| Allowance for loan losses to nonperforming loans | 159.21 %                               | 165.73 % |

Nonperforming loans increased \$690,000, or 22.7%, to \$3.7 million at September 30, 2017 from \$3.0 million at June 30, 2017. This increase was primarily due to two residential mortgage loans in the amount of \$809,000 which were 90 days past due and still accruing at September 30, 2017. Of the \$3.7 million in nonperforming loans, \$1.3 million were not past due at September 30, 2017.

As of September 30, 2017, the Corporation's classified and criticized assets amounted to \$15.2 million, or 2.0% of total assets, with \$11.6 million classified as substandard and \$3.6 million identified as special mention. This compares to classified and criticized assets of \$9.7 million, or 1.3% of total assets, with \$8.0 million classified as substandard and \$1.7 million identified as special mention at June 30, 2017. This increase was primarily related to the risk rating downgrades of one \$1.9 million commercial loan relationship to special mention and one \$2.1 million commercial loan relationship to substandard. In addition, \$592,000 of classified and criticized assets were added through the acquisition of Northern Hancock in September 2017.

The provision for loan losses increased \$102,000, or 60.7%, to \$270,000 for the three months ended September 30, 2017 from \$168,000 for the same period in the prior year due primarily to general growth in the loan portfolio and the aforementioned credit downgrades.

Noninterest income. Noninterest income increased \$1.3 million to \$2.3 million for the three months ended September 30, 2017, compared to \$1.0 million for the same period in 2016. During the quarter ended September 30, 2017, the Corporation recorded a \$1.3 million bargain purchase gain related to the acquisition of Northern Hancock. Partially offsetting this, gains on the sale of loans decreased \$75,000, or 62.0%, to \$46,000 for the three months ended September 30, 2017, compared to \$121,000 during the same period in 2016.

Noninterest expense. Noninterest expense increased \$948,000, or 21.1%, to \$5.4 million for the three months ended September 30, 2017 compared to \$4.5 million for the same period in 2016. This increase due to \$963,000 of expenses related to the acquisition of Northern Hancock.

Acquisition costs totaled \$963,000 for the three months ended September 30, 2017. These costs included system conversion costs, contract termination fees, legal fees, employee severance costs, accounting and auditing fees and other costs of \$344,000, \$279,000, \$108,000, \$108,000, \$46,000 and \$78,000, respectively.

The Corporation recognized \$58,000 of core deposit intangible amortization expense during the third quarter of 2017 compared to \$60,000 for the same period in 2016. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the “Notes to Consolidated Financial Statements” beginning on page 6.

Provision for income taxes. The provision for income taxes increased \$95,000, or 32.0%, to \$392,000 for the three months ended September 30, 2017 compared to \$297,000 for the same period in the prior year. This related to an increase in the Corporation's net income before income taxes, partially offset by a decrease in the Corporation's effective tax rate to 18.7% for the three months ended September 30, 2017 compared to 21.9% for the same period in 2016.

#### Comparison of Results for the Nine Months Ended September 30, 2017 and 2016

General. Net income increased \$914,000, or 32.8%, to \$3.7 million for the nine months ended September 30, 2017 from \$2.8 million for the same period in 2016. This increase was the result of increases in net interest income and noninterest income of \$1.7 million and \$1.3 million, respectively, partially offset by increases in the provision for loans losses, provision for income taxes and noninterest expense of \$163,000, \$98,000 and \$1.8 million, respectively.

Net interest income. Tax equivalent net interest income increased \$1.6 million, or 11.0%, to \$16.5 million for the nine months ended September 30, 2017 from \$14.8 million for the nine months ended September 30, 2016. This increase was attributed to an increase in tax equivalent interest income of \$1.9 million, partially offset by an increase in interest expense of \$292,000.

Interest income. Tax equivalent interest income increased \$1.9 million, or 10.8%, to \$19.7 million for the nine months ended September 30, 2017 from \$17.8 million for the same period in 2016. This increase was attributed to increases in interest earned on loans and interest-earning deposits with bank and dividends on federal bank stocks of \$2.0 million, \$41,000 and \$44,000, respectively, partially offset by a decrease in interest earned on securities of \$140,000.

Tax equivalent interest earned on loans receivable increased \$2.0 million, or 12.7%, to \$17.6 million for the nine months ended September 30, 2017 compared to \$15.6 million for the same period in 2016. This increase resulted from a \$71.1 million, or 15.0% increase in average loans, accounting for an increase of \$2.3 million in interest income. The increase in loans receivable was partially related to the acquisition of United American in April 2016 and strong loan growth achieved in late 2016 and the first nine months of 2017. Partially offsetting this favorable volume variance, the average yield on loans decreased 9 basis points to 4.30% for the nine months ended September 30, 2017, versus 4.39% for the same period in 2016. This unfavorable yield variance accounted for a \$320,000 decrease in interest income.

Tax equivalent interest earned on securities decreased \$140,000, or 7.3%, to \$1.8 million for the nine months ended September 30, 2017 compared to \$1.9 million for the nine months ended September 30, 2016. This decrease resulted from an \$8.9 million, or 8.1%, decrease in the average balance of securities, accounting for a \$158,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 2 basis points to 2.38% for the nine months ended September 30, 2017 versus 2.36% for the same period in 2016. This favorable yield variance accounted for a \$18,000 increase in interest income.

Interest earned on deposits with banks increased \$41,000 to \$151,000 for the nine months ended September 30, 2017 compared to \$110,000 for the nine months ended September 30, 2016. This increase resulted from a 47 basis point increase in the average yield on these accounts to 1.00% for the nine months ended September 30, 2017, versus 0.53% for the same period in 2016, accounting for a \$77,000 increase in interest income. Partially offsetting the favorable yield variance, the average balance of interest-earning deposits decreased \$7.5 million, or 2.7%, accounting for a decrease of \$36,000 in interest income.

Dividends on federal bank stocks increased \$44,000, or 32.6%, to \$179,000 for the nine months ended September 30, 2017 from \$135,000 for the same period in 2016. This increase was primarily due to an increase in the average balance of federal bank stocks of \$1.3 million, or 35.0%, to \$4.9 million compared to \$3.6 million for the same period

in 2016, accounting for a \$46,000 increase in interest income. Partially offsetting the favorable volume variance, the average yield on these assets decreased 8 basis points to 4.92% for the nine months ended September 30, 2017, versus 5.00% for the same period in 2016, accounting for a \$2,000 decrease in interest income.

Interest expense. Interest expense increased \$292,000, or 9.9%, to \$3.2 million for the nine months ended September 30, 2017 from \$2.9 million for the same period in 2016. This increase in interest expense can be attributed to increases in interest incurred on deposits and borrowed funds of \$185,000 and \$107,000, respectively.

Interest expense incurred on deposits increased \$185,000, or 8.8%, to \$2.3 million for the nine months ended September 30, 2017 compared to \$2.2 million for the same period in 2016. The average balance of interest-bearing deposits increased \$48.3 million, or 11.1%, to \$484.9 million for the nine months ended September 30, 2017, compared to \$436.6 million for the same period in 2016 causing a \$228,000 increase in interest expense. This increase was primarily due to the acquisition of United American in April 2016 and strong deposit growth during the first nine months of 2017. Partially offsetting the volume variance, the average cost of interest-bearing deposits decreased one basis point to 0.63% for the nine month ended September 30, 2017, compared to 0.64% for the same period in 2016 causing a \$43,000 decrease in interest expense.

Interest expense incurred on borrowed funds increased \$107,000, or 12.6%, to \$954,000 for the nine months ended September 30, 2017, compared to \$847,000 for the same period in the prior year. The average balance of borrowed funds increased \$5.0 million, or 13.3%, to \$42.2 million for the nine months ended September 30, 2017, compared to \$37.3 million for the same period in 2016 causing a \$104,000 increase in interest expense. Additionally, the average cost of borrowed funds increased 2 basis points to 3.02% for the nine months ended September 30, 2017 compared to 3.04% for the same period in 2016 causing a \$3,000 increase in interest expense.



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

| (Dollar amounts in thousands)           | Nine months ended September 30, |          |            |                 |          |            |
|---|---------------------------------|----------|------------|-----------------|----------|------------|
|   | 2017                            |          |            | 2016            |          |            |
|   | Average Balance                 | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| <b>Interest-earning assets:</b>         |                                 |          |            |                 |          |            |
| Loans, taxable                          | \$522,156                       | \$16,747 | 4.29%      | \$448,711       | \$14,685 | 4.37%      |
| Loans, tax exempt                       | 23,914                          | 833      | 4.66%      | 26,228          | 920      | 4.69%      |
| Total loans receivable                  | 546,070                         | 17,580   | 4.30%      | 474,939         | 15,605   | 4.39%      |
| Securities, taxable                     | 74,128                          | 1,208    | 2.18%      | 80,409          | 1,270    | 2.11%      |
| Securities, tax exempt                  | 26,008                          | 574      | 2.95%      | 28,587          | 652      | 3.05%      |
| Total securities                        | 100,136                         | 1,782    | 2.38%      | 108,996         | 1,922    | 2.36%      |
| Interest-earning deposits with banks    | 20,278                          | 151      | 1.00%      | 27,805          | 110      | 0.53%      |
| Federal bank stocks                     | 4,869                           | 179      | 4.92%      | 3,608           | 135      | 5.00%      |
| Total interest-earning cash equivalents | 25,147                          | 330      | 1.75%      | 31,413          | 245      | 1.04%      |
| Total interest-earning assets           | 671,353                         | 19,692   | 3.92%      | 615,348         | 17,772   | 3.86%      |
| Cash and due from banks                 | 2,684                           |          |            | 2,537           |          |            |
| Other noninterest-earning assets        | 45,882                          |          |            | 41,120          |          |            |
| Total Assets                            | \$719,919                       |          |            | \$659,005       |          |            |
| <b>Interest-bearing liabilities:</b>    |                                 |          |            |                 |          |            |
| Interest-bearing demand deposits        | \$321,177                       | \$685    | 0.28%      | \$286,339       | \$442    | 0.21%      |
| Time deposits                           | 163,746                         | 1,591    | 1.30%      | 150,243         | 1,649    | 1.47%      |
| Total interest-bearing deposits         | 484,923                         | 2,276    | 0.63%      | 436,582         | 2,091    | 0.64%      |
| Borrowed funds, short-term              | 5,237                           | 100      | 2.55%      | 1,925           | 48       | 3.35%      |
| Borrowed funds, long-term               | 37,011                          | 854      | 3.09%      | 35,354          | 799      | 3.02%      |
| Total borrowed funds                    | 42,248                          | 954      | 3.02%      | 37,279          | 847      | 3.04%      |
| Total interest-bearing liabilities      | 527,171                         | 3,230    | 0.82%      | 473,861         | 2,938    | 0.83%      |
| Noninterest-bearing demand deposits     | 127,331                         | —        | —          | 122,133         | —        | —          |
| Funding and cost of funds               | 654,502                         | 3,230    | 0.66%      | 595,994         | 2,938    | 0.66%      |
| Other noninterest-bearing liabilities   | 9,580                           |          |            | 8,731           |          |            |

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|   |           |           |
|---|-----------|-----------|
| Total Liabilities   | 664,082   | 604,725   |
| Stockholders' Equity  | 55,837    | 54,280    |
| Total Liabilities and Stockholders' Equity  | \$719,919 | \$659,005 |
| Net interest income   | \$16,462  | \$14,834  |
| Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) | 3.10%     | 3.03%     |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                | 3.28%     | 3.22%     |

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

| (Dollar amounts in thousands)        | Nine months ended<br>September 30,<br>2017 versus 2016 |         |         |
|--------------------------------------|--|---------|---------|
|                                      | Increase (Decrease) due<br>to                          |         |         |
|                                      | Volume   | Rate    | Total   |
| Interest income:                     |  |         |         |
| Loans                                | \$2,295  | \$(320) | \$1,975 |
| Securities                           | (158 )   | 18      | (140 )  |
| Interest-earning deposits with banks | (36 )  | 77      | 41      |
| Federal bank stocks                  | 46   | (2 )    | 44      |
| Total interest-earning assets        | 2,147  | (227 )  | 1,920   |
| Interest expense:                    |  |         |         |
| Interest-bearing deposits            | 228  | (43 )   | 185     |
| Borrowed funds, short-term           | 66   | (14 )   | 52      |
| Borrowed funds, long-term            | 38   | 17      | 55      |
| Total interest-bearing liabilities   | 332  | (40 )   | 292     |
| Net interest income                  | \$1,815  | \$(187) | \$1,628 |

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

Information pertaining to the allowance for loan losses and nonperforming assets for the nine months ended September 30, 2017 and 2016 is as follows:

| (Dollar amounts in thousands)                    | As of or for the<br>nine months ended |          |
|--|---------------------------------------|----------|
|  | September 30,<br>2017                 | 2016     |
| Balance at the beginning of the period           | \$5,545                               | \$5,205  |
| Provision for loan losses                        | 633                                   | 470      |
| Charge-offs                                      | (275 )                                | (182 )   |
| Recoveries                                       | 37                                    | 21       |
| Balance at the end of the period                 | \$5,940                               | \$5,514  |
| Nonperforming loans                              | \$3,731                               | \$3,327  |
| Nonperforming assets                             | 4,160                                 | 3,508    |
| Nonperforming loans to total loans               | 0.64 %                                | 0.65 %   |
| Nonperforming assets to total assets             | 0.54 %                                | 0.51 %   |
| Allowance for loan losses to total loans         | 1.02 %                                | 1.07 %   |
| Allowance for loan losses to nonperforming loans | 159.21 %                              | 165.73 % |

Nonperforming loans increased \$408,000, or 12.3%, to \$3.7 million at September 30, 2017 from \$3.3 million at December 31, 2016. This increase was primarily due to two residential mortgage loans totaling \$809,000 which were 90 days past due and still accruing at September 30, 2017, partially offset by the payoff of two residential mortgage loans which were previously on nonaccrual status totaling \$391,000. Of the \$3.7 million in nonperforming loans, \$1.3 million were not past due at September 30, 2017.

As of September 30, 2017, the Corporation's classified and criticized assets amounted to \$15.2 million, or 2.0% of total assets, with \$11.6 million classified as substandard and \$3.6 million identified as special mention. This compares to classified and criticized assets of \$12.8 million, or 1.9% of total assets, with \$6.8 million classified as substandard and \$6.0 million identified as special mention at December 31, 2016. This increase was primarily related to the risk rating downgrades of one \$1.9 million commercial loan relationship to special mention and one \$2.1 million commercial loan relationship to substandard. In addition, \$592,000 of classified and criticized assets were added through the acquisition of Northern Hancock in September 2017. Partially offsetting these increases, there was a risk rating upgrade of one commercial loan relationship totaling \$4.5 million.

The provision for loan losses increased \$163,000, or 34.7%, to \$633,000 for the nine months ended September 30, 2017 from \$470,000 for the same period in the prior year due primarily to general growth in the loan portfolio.

Noninterest income. Noninterest income increased \$1.3 million, or 46.2%, to \$4.0 million for the nine months ended September 30, 2017 compared to \$2.7 million for the same period in 2016. During the nine months ended September 30, 2017, the Corporation recorded the aforementioned \$1.3 million bargain purchase gain related to the acquisition of Northern Hancock. Also during the nine months ended September 30, 2017, the Corporation recorded a \$508,000 other-than-temporary impairment charge on a subordinated debt investment issued by First NBC Bank Holding Company. On April 28, 2017, the Louisiana Office of Financial Institutions closed First NBC Bank, the wholly owned banking subsidiary of First NBC Bank Holding Company, and named the FDIC as receiver for the bank. Partially offsetting this impairment charge, the Corporation realized securities gains of \$350,000 during the nine months ended September 30, 2017, compared to \$83,000 during the same period in 2016. Additionally, gains on the sale of loans totaled \$176,000 for the nine months ended September 30, 2017 compared to \$121,000 during the same period in

2016 and customer service fees increased \$126,000 as overdraft charges for the first nine months of 2017 outpaced the same period last year.

Noninterest expense. Noninterest expense increased \$1.8 million, or 13.6%, to \$14.7 million for the nine months ended September 30, 2017 compared to \$13.0 million for the same period in 2016. This increase in noninterest expense can be attributed to increases in acquisition costs, compensation and benefits, other noninterest expense, premises and equipment, professional fees, federal deposit insurance and intangible asset amortization of \$668,000, \$473,000, \$469,000, \$93,000, \$30,000, \$20,000 and \$12,000, respectively.

Acquisition costs increased \$668,000 to \$1.1 million for the nine months ended September 30, 2017 compared to \$401,000 for the same period in 2016. Acquisition costs for the nine months ended September 30, 2017 were related to the acquisition of Northern Hancock and included system conversion costs, contract termination fees, legal fees, employee severance costs, accounting and auditing fees and other costs of \$344,000, \$279,000, \$200,000, \$108,000, \$55,000 and \$84,000, respectively. Acquisition costs for the nine months ended September 30, 2016 were related to the acquisition of United American and included legal fees, system conversion costs and other costs of \$194,000, \$132,000 and \$75,000, respectively.

Compensation and employee benefits expense increased \$473,000, or 7.3%, to \$7.0 million for the nine months ended September 30, 2017 compared to \$6.5 million for the same period in the prior year. This increase was primarily the result of increases in salaries, incentive compensation, retirement benefits, insurance benefits and payroll taxes of \$165,000, \$87,000, \$70,000, \$50,000 and \$33,000, respectively. The increases in compensation and employee benefits related expenses were due primarily to normal salary and wage increases, the addition of the branch office in the United American acquisition in April 2016 and the opening of the new Aspinwall branch office in August 2016.

Premises and equipment expense increased \$93,000, or 4.4%, to \$2.2 million for the nine months ended September 30, 2017 compared to \$2.1 million for the same period in the prior year. This increase was primarily the result of the two new branch offices which added \$199,000 of expense for the nine months ended September 30, 2017 compared to \$130,000 for the same period in 2016.

Other noninterest expense increased \$469,000, or 15.8%, to \$3.4 million for the nine months ended September 30, 2017 compared to \$3.0 million for the same period in the prior year. Contributing to the increase were increases in bad checks and other losses, Pennsylvania shares tax, overdraft privilege program administration fees, debit card processing expenses, subscriptions, correspondent banking fees, travel and entertainment expenses, telecommunications expenses and operating costs of associated with the two new branch offices.

The Corporation recognized \$177,000 of core deposit intangible amortization expense during the first nine months of 2017 compared to \$165,000 for the same period in 2016. This amortization relates to a branch acquisition completed in the third quarter of 2009 and the United American acquisition completed in April 2016. Further discussion of goodwill and intangible assets related to the acquisitions can be found in Note 2 to the "Notes to Consolidated Financial Statements" beginning on page 6.

Provision for income taxes. The provision for income taxes increased \$98,000 to \$978,000 for the nine months ended September 30, 2017 compared to \$880,000 for the same period in the prior year. This related to an increase in the Corporation's net income before income taxes, partially offset by a decrease in the Corporation's effective tax rate to 20.9% for the nine months ended September 30, 2017 compared to 24.0% for the same period in 2016. The decrease in the Corporation's effective tax rate was due to certain nondeductible merger related expenses and the non-taxable nature of the gain on bargain purchase incurred in the first nine months of 2016.

## LIQUIDITY

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB, Federal Reserve and other correspondent banks, and amortization and prepayments of outstanding loans and maturing securities. During the nine months ended September 30, 2017, the Corporation used its sources of funds primarily to fund loan advances and repay short term borrowed funds. As of September 30, 2017, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$72.6 million, and standby letters of credit totaling \$66,000, net of collateral maintained by the Bank.

At September 30, 2017, time deposits amounted to \$172.6 million, or 26.1% of the Corporation's total consolidated deposits, including approximately \$53.2 million of which are scheduled to mature within the next year. Management of the Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation 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 September 30, 2017, the Corporation had borrowed funds of \$41.3 million consisting of \$35.0 million of long-term FHLB advances, a \$3.8 million long-term advance with a correspondent bank and \$2.5 million outstanding on a line of credit with a correspondent bank. At September 30, 2017, the Corporation's borrowing capacity with the FHLB, net of funds borrowed and irrevocable standby letters of credit issue to secure certain deposit accounts, was \$170.1 million.

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

#### RECENT REGULATORY DEVELOPMENTS

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

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

#### CRITICAL ACCOUNTING POLICIES

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

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016. These policies, along with the disclosures presented in the other financial statement notes provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies.

**Allowance for loan losses.** The Corporation considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than its other significant accounting policies. The balance in the allowance for loan losses is determined based on management's review and evaluation of the loan portfolio in relation



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

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

Goodwill and intangible assets. Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step is to determine the amount of the impairment. If the tests conclude that goodwill is impaired, the carrying value is adjusted and an impairment charge is recorded. As of November 30, 2016, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values.

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

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

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

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

Assumptions about the timing and variability of cash flows are critical in gap analysis. Particularly important are the assumptions driving mortgage prepayments and the expected attrition of the core deposits portfolios. These assumptions are based on the Corporation's historical experience, industry standards and assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation's

assets and liabilities to interest rate changes. As of September 30, 2017, the Corporation's interest-earning assets maturing or repricing within one year totaled \$223.7 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$171.6 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$52.1 million. At September 30, 2017, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 130.3%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016.

Item 4. Controls and Procedures

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

As of September 30, 2017, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective. There have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

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

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

Not applicable.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

(a) Not applicable.

(b)Not applicable.

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Item 6. Exhibits

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

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

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

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

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definitions Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Signatures

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

EMCLAIRE  
FINANCIAL CORP

Date: November 13, 2017 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: November 13, 2017 By: /s/ Amanda L. Engles  
Amanda L. Engles  
Chief Financial Officer  
Treasurer