

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
November 13, 2012

**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, 2012**

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.)

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

16373  
(Zip Code)

(724) 867-2311  
(Registrant's telephone number)

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

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

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

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

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

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

The number of shares outstanding of the Registrant's common stock was 1,751,908 at November 13, 2012.

**EMCLAIRE FINANCIAL CORP**

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

Emclaire Financial Corp

Consolidated Balance Sheets

As of September 30, 2012 (Unaudited) and December 31, 2011

(Dollar amounts in thousands, except per share data)

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Assets  |                       |                      |
| Cash and due from banks   | \$ 2,165              | \$ 2,516             |
| Interest earning deposits with banks                                      | 20,862                | 25,677               |
| Cash and cash equivalents   | 23,027                | 28,193               |
| Securities available for sale, at fair value                              | 143,621               | 123,154              |
| Loans receivable, net of allowance for loan losses of \$5,023 and \$3,536 | 331,431               | 312,545              |
| Federal bank stocks, at cost  | 3,171                 | 3,664                |
| Bank-owned life insurance   | 9,989                 | 5,809                |
| Accrued interest receivable   | 1,736                 | 1,630                |
| Premises and equipment, net   | 8,952                 | 9,026                |
| Goodwill  | 3,664                 | 3,664                |
| Core deposit intangible, net  | 1,308                 | 1,580                |
| Prepaid expenses and other assets   | 3,274                 | 2,617                |
| Total Assets  | \$ 530,173            | \$ 491,882           |
| Liabilities and Stockholders' Equity                                      |                       |                      |
| Liabilities:  |                       |                      |
| Deposits:   |                       |                      |
| Non-interest bearing  | \$ 102,790            | \$ 84,871            |
| Interest bearing  | 350,707               | 331,597              |
| Total deposits  | 453,497               | 416,468              |
| Long-term borrowed funds  | 20,000                | 20,000               |
| Accrued interest payable  | 516                   | 541                  |
| Accrued expenses and other liabilities                                    | 3,995                 | 4,143                |
| Total Liabilities   | 478,008               | 441,152              |

|  |            |            |
|--|------------|------------|
| Commitments and Contingent Liabilities   | -          | -          |
| Stockholders' Equity:  |            |            |
| Preferred stock, \$1.00 per value, 3,000,000 shares authorized; Series B, non-cumulative preferred stock, \$10,000 liquidation value, 10,000 shares issued and outstanding, respectively | 10,000     | 10,000     |
| Common stock, \$1.25 par value, 12,000,000 shares authorized; 1,853,925 shares issued; 1,751,908 shares outstanding  | 2,317      | 2,317      |
| Additional paid-in capital   | 19,247     | 19,155     |
| Treasury stock, at cost; 102,017 shares  | (2,114 )   | (2,114 )   |
| Retained earnings  | 21,598     | 19,948     |
| Accumulated other comprehensive income   | 1,117      | 1,424      |
| Total Stockholders' Equity   | 52,165     | 50,730     |
| Total Liabilities and Stockholders' Equity   | \$ 530,173 | \$ 491,882 |

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, 2012 and 2011

(Dollar amounts in thousands, except per share data)

|   | For the three months ended<br>September 30, |          | For the nine months ended<br>September 30, |           |
|---|---|----------|--|-----------|
|   | 2012  | 2011     | 2012                                       | 2011      |
| Interest and dividend income:                       |   |          |  |           |
| Loans receivable, including fees                    | \$ 4,389                                    | \$ 4,345 | \$ 12,989                                  | \$ 12,983 |
| Securities:   |   |          |  |           |
| Taxable   | 617   | 643      | 1,763                                      | 1,762     |
| Exempt from federal income tax                      | 287   | 325      | 873  | 974       |
| Federal bank stocks                                 | 15  | 13       | 46   | 39        |
| Interest earning deposits with banks                | 17  | 40       | 68   | 141       |
| Total interest and dividend income                  | 5,325                                       | 5,366    | 15,739                                     | 15,899    |
| Interest expense:                                   |   |          |  |           |
| Deposits  | 1,008                                       | 1,178    | 3,105                                      | 3,561     |
| Borrowed funds                                      | 238   | 275      | 707  | 948       |
| Total interest expense                              | 1,246                                       | 1,453    | 3,812                                      | 4,509     |
| Net interest income                                 | 4,079                                       | 3,913    | 11,927                                     | 11,390    |
| Provision for loan losses                           | 1,359                                       | 80       | 1,587                                      | 320       |
| Net interest income after provision for loan losses | 2,720                                       | 3,833    | 10,340                                     | 11,070    |
| Noninterest income:                                 |   |          |  |           |
| Fees and service charges                            | 428   | 395      | 1,159                                      | 1,108     |
| Commissions on financial services                   | 158   | 92       | 383  | 396       |
| Title premiums                                      | 13  | 11       | 46   | 65        |
| Net gain on sales of available for sale securities  | 390   | -        | 1,352                                      | 482       |
| Earnings on bank-owned life insurance               | 81  | 62       | 205  | 183       |
| Other   | 303   | 265      | 868  | 743       |
| Total noninterest income                            | 1,373                                       | 825      | 4,013                                      | 2,977     |
| Noninterest expense:                                |   |          |  |           |
| Compensation and employee benefits                  | 1,678                                       | 1,737    | 5,488                                      | 5,368     |
| Premises and equipment                              | 509   | 530      | 1,527                                      | 1,668     |
| Intangible asset amortization                       | 86  | 110      | 272  | 348       |
| Professional fees                                   | 135   | 192      | 510  | 538       |
| Federal deposit insurance                           | 92  | 116      | 282  | 414       |
| Other   | 857   | 710      | 2,476                                      | 2,420     |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Total noninterest expense                        | 3,357     | 3,395     | 10,555    | 10,756    |
| Income before provision for income taxes         | 736       | 1,263     | 3,798     | 3,291     |
| Provision for income taxes                       | 67        | 214       | 835       | 611       |
| Net income                                       | 669       | 1,049     | 2,963     | 2,680     |
| Preferred stock dividends and discount accretion | 118       | 201       | 368       | 397       |
| Net income available to common stockholders      | \$ 551    | \$ 848    | \$ 2,595  | \$ 2,283  |
| Basic and diluted earnings per common share      | \$ 0.31   | \$ 0.49   | \$ 1.48   | \$ 1.38   |
| Average common shares outstanding                | 1,751,908 | 1,747,408 | 1,751,908 | 1,652,865 |
| Comprehensive income                             | \$ 705    | \$ 2,930  | \$ 2,656  | \$ 4,998  |

See accompanying notes to consolidated financial statements.



**Emclaire Financial Corp**

## Condensed Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended September 30, 2012 and 2011

(Dollar amounts in thousands)

|   | For the nine months ended<br>September 30, |           |
|---|--|-----------|
|   | 2012                                       | 2011      |
| Cash flows from operating activities  |  |           |
| Net income  | \$ 2,963                                   | \$ 2,680  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |  |           |
| Depreciation and amortization   | 505  | 605       |
| Provision for loan losses   | 1,587                                      | 320       |
| Amortization of premiums and (accretion of discounts), net                                  | 92   | 170       |
| Amortization of intangible assets and mortgage servicing rights                             | 277  | 360       |
| Realized gains on sales of available for sale securities, net                               | (1,352 )                                   | (482 )    |
| Net losses on foreclosed real estate  | 21   | 8         |
| Restricted stock and stock option compensation  | 92   | 71        |
| Increase in bank-owned life insurance, net  | (180 )                                     | (159 )    |
| (Increase) decrease in accrued interest receivable  | (106 )                                     | 105       |
| (Increase) decrease in prepaid expenses and other assets                                    | (643 )                                     | 321       |
| Decrease in accrued interest payable  | (25 )                                      | (105 )    |
| Increase (decrease) in accrued expenses and other liabilities                               | (13 )                                      | 742       |
| Net cash provided by operating activities   | 3,218                                      | 4,636     |
| Cash flows from investing activities  |  |           |
| Loan originations and principal collections, net  | (20,975 )                                  | (1,542 )  |
| Available for sale securities:  |  |           |
| Sales   | 11,639                                     | 27,493    |
| Maturities, repayments and calls  | 78,146                                     | 49,026    |
| Purchases   | (109,243 )                                 | (76,326 ) |
| Redemption of federal bank stocks   | 493  | 324       |
| Proceeds from the sale of foreclosed real estate  | 271  | 499       |
| Write-down of foreclosed real estate  | -  | 5         |
| Purchases of premises and equipment   | (431 )                                     | (450 )    |
| Purchase of bank-owned life insurance   | (4,000 )                                   | -         |
| Net cash used in investing activities   | (44,100 )                                  | (971 )    |
| Cash flows from financing activities  |  |           |
| Net increase in deposits  | 37,029                                     | 8,397     |
| Repayments on Federal Home Loan Bank advances   | -  | (5,000 )  |
| Repayments on other borrowed funds  | -  | (5,000 )  |
| Dividends paid  | (1,313 )                                   | (1,136 )  |
| Proceeds from the issuance of common stock  | -  | 4,577     |

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|  |           |           |
|--|-----------|-----------|
| Proceeds from the issuance of preferred stock (Series B) | -         | 10,000    |
| Redemption of preferred stock (Series A)                 | -         | (7,500 )  |
| Net cash provided by financing activities                | 35,716    | 4,338     |
| Increase (decrease) in cash and cash equivalents         | (5,166 )  | 8,003     |
| Cash and cash equivalents at beginning of period         | 28,193    | 19,027    |
| Cash and cash equivalents at end of period               | \$ 23,027 | \$ 27,030 |
| Supplemental information:                                |           |           |
| Interest paid  | \$ 3,837  | \$ 4,614  |
| Income taxes paid  | 1,465     | 115       |
| Supplemental noncash disclosure:                         |           |           |
| Transfers from loans to foreclosed real estate           | 288       | 492       |

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, 2012 and 2011

(Dollar amounts in thousands, except per share data)

|   | For the three months ended |           | For the nine months ended |           |
|---|----------------------------|-----------|---------------------------|-----------|
|   | September 30,<br>2012      | 2011      | September 30,<br>2012     | 2011      |
| Balance at beginning of period  | \$ 51,862                  | \$ 45,121 | \$ 50,730                 | \$ 39,118 |
| Net income  | 669                        | 1,049     | 2,963                     | 2,680     |
| Other comprehensive income:   |                            |           |                           |           |
| Change in net unrealized gains (losses) on available for sale securities, net of taxes of \$151, \$969, \$302 and \$1,358, respectively | 293                        | 1,881     | 585                       | 2,636     |
| Less: reclassification adjustment for gains included in net income, net of taxes of \$133, \$0, \$460 and \$164, respectively           | 257                        | -         | 892                       | 318       |
| Other comprehensive income (loss)   | 36                         | 1,881     | (307 )                    | 2,318     |
| Total comprehensive income  | 705                        | 2,930     | 2,656                     | 4,998     |
| Stock compensation expense  | 31                         | 14        | 92                        | 71        |
| Dividends declared on preferred stock   | (118 )                     | (157 )    | (368 )                    | (344 )    |
| Dividends declared on common stock  | (315 )                     | (280 )    | (945 )                    | (792 )    |
| Issuance of common stock (290,004 shares)   | -                          | -         | -                         | 4,577     |
| Issuance of preferred stock (10,000 shares, Series B)   | -                          | 10,000    | -                         | 10,000    |
| Redemption of preferred stock (7,500 shares, Series A)  | -                          | (7,500 )  | -                         | (7,500 )  |
| Balance at end of period  | \$ 52,165                  | \$ 50,128 | \$ 52,165                 | \$ 50,128 |
| Common cash dividend per share  | \$ 0.18                    | \$ 0.16   | \$ 0.54                   | \$ 0.48   |

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 company 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, 2011, as contained in the Corporation's 2011 Annual Report on Form 10-K filed with the SEC.

The balance sheet at December 31, 2011 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. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, goodwill, real estate owned, the valuation of deferred tax assets and other-than-temporary impairment charges on securities. The results of operations for interim quarterly or year-to-date periods are not necessarily indicative of the results that may be expected for the entire year or any other period. Certain amounts previously reported may have been reclassified to conform to the current year's financial statement presentation.

**2. Issuance of Common Stock**

On March 31, 2011, the Corporation sold 290,004 shares of common stock, par value \$1.25 per share, in a private offering to accredited individual and institutional investors at \$15.95 per share. The Corporation realized \$4.6 million in proceeds from the offering net of \$48,000 of direct costs relating to the offering.

**3. Participation in the Small Business Lending Fund (SBLF) of the U.S. Treasury Department (U.S. Treasury) and Repurchase of Shares Issued Under the Troubled Asset Relief Program (TARP)**

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$10.0 million. The issuance was pursuant to the U.S. Treasury's SBLF program, a \$30.0 billion fund established under the Small Business Jobs Act of 2010, which encouraged lending to small businesses by providing capital to qualified community banks with assets less than \$10.0 billion. The Series B Preferred Stock is entitled to receive non-cumulative dividends payable quarterly on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate liquidation amount, has been initially set at 5% per annum based upon the current level of Qualified Small Business Lending (QSBL) by the Bank. The dividend rate for future periods is set based upon the percentage change in qualified lending between each dividend period and the baseline QSBL level established at the time the Agreement was entered into. Such dividend rate may vary from 1% per annum to 5% per annum for the second through tenth dividend periods, and from 1% per annum to 7% per annum for the eleventh through the eighteenth dividend periods. If the Series B Preferred Stock remains outstanding for more than four-and-one-half years, the dividend rate will be fixed at 9%. Prior to that time, in general, the dividend rate decreases as the level of the Bank's QSBL increases. The average dividend rate for the first nine months of 2012 was 4.9%. Such dividends are not cumulative, but the Corporation may only declare and pay dividends on its common stock (or any other equity securities junior to the Series B Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series B Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities.

Holders of the Series B Preferred Stock have the right to vote as a separate class on certain matters relating to the rights of holders of Series B Preferred Stock and on certain corporate transactions. Except with respect to such matters, the Series B Preferred Stock does not have voting rights.

The Corporation may redeem the shares of Series B Preferred Stock, in whole or in part, at any time at a redemption price equal to the sum of the liquidation amount and the per-share amount of any unpaid dividends for the then-current period, subject to any required prior approval by the Corporation's primary federal banking regulator. If paid in part, payments are required to be at least 25% of the original proceeds.

Under the Agreement, the Corporation also repurchased 7,500 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (Series A Preferred Stock) which was issued on December 23, 2008 to the U.S. Treasury in association with participation in the TARP Capital Purchase Program (TARP/PPP) of the Emergency Economic Stabilization Act of 2008 (EESA). The Series A Preferred Stock was fully repurchased for the sum of the liquidation amount of \$1,000 per share and all accrued and unpaid dividends then due, for a total repurchase amount of \$7.5 million.

As part of the 2008 TARP transaction, the Corporation issued a warrant to the U.S. Treasury to purchase 50,111 shares of the Corporation's common stock, par value \$1.25 per share, for \$22.45 per share over a 10-year term. On December 7, 2011, the Corporation repurchased the warrant from the U.S. Treasury for a purchase price of \$51,000.

#### **4. Earnings per Common Share**

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



#### 4. Earnings per Common Share (continued)

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

| (Dollar amounts in thousands, except for per share amounts)   | For the three months ended<br>September 30, |           | For the nine months ended<br>September 30, |           |
|---|---|-----------|--|-----------|
|   | 2012  | 2011      | 2012                                       | 2011      |
| <u>Earnings per common share - basic</u>  |   |           |  |           |
| Net income  | \$ 669                                      | \$ 1,049  | \$ 2,963                                   | \$ 2,680  |
| Preferred stock dividends and discount accretion  | 118   | 201       | 368  | 397       |
| Net income available to common stockholders   | \$ 551                                      | \$ 848    | \$ 2,595                                   | \$ 2,283  |
| Average common shares outstanding   | 1,751,908                                   | 1,747,408 | 1,751,908                                  | 1,652,865 |
| Basic earnings per common share   | \$ 0.31                                     | \$ 0.49   | \$ 1.48                                    | \$ 1.38   |
| <br><u>Earnings per common share - diluted</u>  |   |           |  |           |
| Net income available to common stockholders   | \$ 551                                      | \$ 848    | \$ 2,595                                   | \$ 2,283  |
| Average common shares outstanding   | 1,751,908                                   | 1,747,408 | 1,751,908                                  | 1,652,865 |
| Add: Dilutive effects of assumed exercises of stock options   | -   | 2,059     | -  | 2,688     |
| Average shares and dilutive potential common shares   | 1,751,908                                   | 1,749,467 | 1,751,908                                  | 1,655,553 |
| Diluted earnings per common share   | \$ 0.31                                     | \$ 0.49   | \$ 1.48                                    | \$ 1.38   |
| Stock options, restricted stock awards and warrants not considered in computing diluted earnings per share because they were antidilutive | 84,000                                      | 148,861   | 84,000                                     | 148,861   |

#### 5. Securities

The following table summarizes the Corporation's securities as of September 30, 2012 and December 31, 2011:

| (Dollar amounts in thousands)                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Available for sale:                              |                   |                              |                               |               |
| September 30, 2012:                              |                   |                              |                               |               |
| U.S. Treasury and federal agency                 | \$ 3,958          | \$ 23                        | \$ -                          | \$ 3,981      |
| U.S. government sponsored entities and agencies  | 44,737            | 229                          | -                             | 44,966        |
| Mortgage-backed securities: residential          | 23,260            | 1,915                        | -                             | 25,175        |
| Collateralized mortgage obligations: residential | 26,265            | 2                            | (100 )                        | 26,167        |
| State and political subdivisions                 | 35,390            | 2,009                        | -                             | 37,399        |
| Corporate debt securities                        | 3,730             | 29                           | (1 )                          | 3,758         |

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|   |            |          |         |   |            |
|---|------------|----------|---------|---|------------|
| Equity securities                               | 2,280      | 4        | (109    | ) | 2,175      |
|   | \$ 139,620 | \$ 4,211 | \$ (210 | ) | \$ 143,621 |
| December 31, 2011:                              |            |          |         |   |            |
| U.S. Treasury and federal agency                | \$ 3,944   | \$ 516   | \$ -    |   | \$ 4,460   |
| U.S. government sponsored entities and agencies | 41,425     | 102      | (7      | ) | 41,520     |
| Mortgage-backed securities: residential         | 35,651     | 1,827    | -       |   | 37,478     |
| State and political subdivisions                | 35,073     | 1,928    | (1      | ) | 37,000     |
| Equity securities                               | 2,595      | 308      | (207    | ) | 2,696      |
|   | \$ 118,688 | \$ 4,681 | \$ (215 | ) | \$ 123,154 |

## 5. Securities (continued)

The following table summarizes scheduled maturities of the Corporation's debt securities as of September 30, 2012. 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<br>Cost  | Fair<br>Value |
| Due in one year or less                          | \$252              | \$255         |
| Due after one year through five years            | 44,228             | 44,718        |
| Due after five through ten years                 | 37,787             | 39,335        |
| Due after ten years                              | 5,548              | 5,796         |
| Mortgage-backed securities: residential          | 23,260             | 25,175        |
| Collateralized mortgage obligations: residential | 26,265             | 26,167        |
|  | \$137,340          | \$141,446     |

Information pertaining to securities with gross unrealized losses at September 30, 2012 and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| (Dollar amounts in thousands)                       | Less than 12 Months |                    | 12 Months or More |                    | Total         |                    |
|---|---------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|   | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| September 30, 2012:                                 |                     |                    |                   |                    |               |                    |
| Collateralized mortgage obligations:<br>residential | \$ 22,159           | \$ (100 )          | \$ -              | \$ -               | \$22,159      | \$ (100 )          |
| Corporate debt securities                           | 760                 | (1 )               | -                 | -                  | 760           | (1 )               |
| Equity securities                                   | 309                 | (11 )              | 1,198             | (98 )              | 1,507         | (109 )             |
|   | \$ 23,228           | \$ (112 )          | \$ 1,198          | \$ (98 )           | \$24,426      | \$ (210 )          |
| December 31, 2011:                                  |                     |                    |                   |                    |               |                    |
| U.S. government sponsored entities and<br>agencies  | \$ 4,490            | \$ (7 )            | \$ -              | \$ -               | \$4,490       | \$ (7 )            |
| State and political subdivisions                    | 99                  | (1 )               | -                 | -                  | 99            | (1 )               |
| Equity securities                                   | 881                 | (185 )             | 187               | (22 )              | 1,068         | (207 )             |
|   | \$ 5,470            | \$ (193 )          | \$ 187            | \$ (22 )           | \$5,657       | \$ (215 )          |

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

| (Dollar amounts in thousands)  | For the three months<br>ended September 30, |      | For the nine months<br>ended September 30, |           |
|--------------------------------|---|------|--|-----------|
|                                | 2012  | 2011 | 2012                                       | 2011      |
| Proceeds                       | \$ 6,043                                    | \$ - | \$ 11,639                                  | \$ 27,493 |
| Gains                          | 390   | -    | 1,352                                      | 482       |
| Tax provision related to gains | 133   | -    | 460  | 164       |

**5. Securities (continued)**

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 debt security or more likely than not will be required to sell the debt 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.

There were six equity securities in an unrealized loss position as of September 30, 2012, two of which were in an unrealized loss position for more than 12 months. Equity securities owned by the Corporation consist of common stock of various financial service providers. These investment securities are in an unrealized loss position as a result of recent market volatility and depressed pricing of the financial services sector. 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 and capital adequacy and all other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the equity securities with unrealized losses as of September 30, 2012 to be other-than-temporarily impaired.

There were 12 debt securities in an unrealized loss position as of September 30, 2012, all of which were in an unrealized loss position for less than 12 months. Of these securities, nine were collateralized mortgage obligations and three were corporate debt securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that is likely to result in the failure to collect contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of September 30, 2012 to be other-than-temporarily impaired.

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

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

| (Dollar amounts in thousands)         | September 30,<br>2012 | December 31,<br>2011 |
|---------------------------------------|-----------------------|----------------------|
| Mortgage loans on real estate:        |                       |                      |
| Residential first mortgages           | \$ 96,031             | \$ 93,610            |
| Home equity loans and lines of credit | 80,635                | 71,238               |
| Commercial real estate                | 96,786                | 94,765               |
|                                       | 273,452               | 259,613              |
| Other loans:                          |                       |                      |
| Commercial business                   | 50,791                | 43,826               |
| Consumer                              | 12,211                | 12,642               |
|                                       | 63,002                | 56,468               |
| Total loans, gross                    | 336,454               | 316,081              |
| Less allowance for loan losses        | 5,023                 | 3,536                |
| Total loans, net                      | \$ 331,431            | \$ 312,545           |

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of September 30, 2012:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |  |   | For the three months              |  | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|--|--|---|-----------------------------------|--|---|
|                                 | As of September 30, 2012               |  |   | ended September 30, 2012          |  |   |
|                                 | Unpaid<br>Principal<br>Balance         | Recorded<br>Investment                     | Related<br>Allowance                              | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |   |
| Residential first mortgages     | \$-                                    | \$ -                                       | \$ -  | \$ -                              | \$ -                                       | \$ -  |
| Home equity and lines of credit | -                                      | -  | -   | -                                 | -  | -   |
| Commercial real estate          | 4,310                                  | 4,136                                      | 1,579   | 2,423                             | 203  | 10  |
| Commercial business             | -                                      | -  | -   | -                                 | -  | -   |
| Consumer                        | -                                      | -  | -   | -                                 | -  | -   |
| <b>Total</b>                    | <b>\$4,310</b>                         | <b>\$ 4,136</b>                            | <b>\$ 1,579</b>                                   | <b>\$ 2,423</b>                   | <b>\$ 203</b>                              | <b>\$ 10</b>                                      |
|                                 | For the nine months                    |  |   | For the three months              |  |   |
|                                 | ended September 30, 2012               |  |   | ended September 30, 2012          |  |   |
|                                 | Average<br>Recorded<br>Investment      | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |                                   |  |   |
| Residential first mortgages     | \$ -                                   | \$ -                                       | \$ -  |                                   |  |   |
| Home equity and lines of credit | -                                      | -  | -   |                                   |  |   |
| Commercial real estate          | 1,577                                  | 240  | 47  |                                   |  |   |
| Commercial business             | 47                                     | -  | -   |                                   |  |   |
| Consumer                        | -                                      | -  | -   |                                   |  |   |
| <b>Total</b>                    | <b>\$ 1,624</b>                        | <b>\$ 240</b>                              | <b>\$ 47</b>                                      |                                   |  |   |

**Impaired Loans with No Specific Allowance**

|  | As of September 30, 2012       |                        | For the three months              |  | Cash Basis<br>Interest<br>Recognized<br>in Period |
|--|--------------------------------|------------------------|-----------------------------------|--|---|
|  | ended September 30, 2012       |                        | ended September 30, 2012          |  |   |
|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period |   |
|  |                                |                        |                                   |  |   |

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|                                 |         |         |         |      |      |
|---------------------------------|---------|---------|---------|------|------|
| Residential first mortgages     | \$-     | \$-     | \$-     | \$-  | \$-  |
| Home equity and lines of credit | -       | -       | -       | -    | -    |
| Commercial real estate          | 750     | 525     | 530     | 8    | 8    |
| Commercial business             | 399     | 374     | 376     | -    | -    |
| Consumer                        | 1,712   | 1,712   | 1,742   | 35   | 35   |
| Total                           | \$2,861 | \$2,611 | \$2,648 | \$43 | \$43 |

For the nine months  
ended September 30, 2012

|                                 | Average<br>Recorded<br>Investment in<br>Period | Interest<br>Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|--|---|---|
| Residential first mortgages     | \$ -   | \$ -  | \$ -  |
| Home equity and lines of credit | -  | -   | -   |
| Commercial real estate          | 736  | 37  | 37  |
| Commercial business             | 367  | 10  | 10  |
| Consumer                        | 1,806  | 117   | 117   |
| Total                           | \$ 2,909                                       | \$ 164  | \$ 164  |

During the three and nine month periods ended September 30, 2011, impaired loans averaged \$4.5 million and \$3.7 million, respectively, and the Corporation recognized interest income on impaired loans of approximately \$65,000 and \$143,000, respectively, on a cash basis.



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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2011:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                     |                   | For the year ended          |                               | Cash Basis Interest Recognized in Period |
|---------------------------------|--|---------------------|-------------------|-----------------------------|-------------------------------|--|
|                                 | As of December 31, 2011                |                     |                   | December 31, 2011           |                               |  |
|                                 | Unpaid Principal Balance               | Recorded Investment | Related Allowance | Average Recorded Investment | Interest Recognized in Period |  |
| Residential first mortgages     | \$-                                    | \$ -                | \$ -              | \$-                         | \$ -                          | \$ -                                     |
| Home equity and lines of credit | -                                      | -                   | -                 | -                           | -                             | -  |
| Commercial real estate          | 524                                    | 524                 | 142               | 616                         | 39                            | 26                                       |
| Commercial business             | 128                                    | 128                 | 22                | 771                         | 7                             | 2  |
| Consumer                        | -                                      | -                   | -                 | -                           | -                             | -  |
| <b>Total</b>                    | <b>\$652</b>                           | <b>\$ 652</b>       | <b>\$ 164</b>     | <b>\$1,387</b>              | <b>\$ 46</b>                  | <b>\$ 28</b>                             |

|                                 | Impaired Loans with No Specific Allowance |                     |                | For the year ended          |                               | Cash Basis Interest Recognized in Period |
|---------------------------------|---|---------------------|----------------|-----------------------------|-------------------------------|--|
|                                 | As of December 31, 2011                   |                     |                | December 31, 2011           |                               |  |
|                                 | Unpaid Principal Balance                  | Recorded Investment |                | Average Recorded Investment | Interest Recognized in Period |  |
| Residential first mortgages     | \$-                                       | \$ -                | \$-            | \$ -                        | \$ -                          | \$ -                                     |
| Home equity and lines of credit | -   | -                   | -              | -                           | -                             | -  |
| Commercial real estate          | 1,518                                     | 1,154               | 862            | 81                          | 81                            | 81                                       |
| Commercial business             | 357                                       | 332                 | 122            | 27                          | 6                             | 6  |
| Consumer                        | 1,905                                     | 1,905               | 2,018          | 138                         | 138                           | 138                                      |
| <b>Total</b>                    | <b>\$3,780</b>                            | <b>\$ 3,391</b>     | <b>\$3,002</b> | <b>\$ 246</b>               | <b>\$ 225</b>                 | <b>\$ 225</b>                            |

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

***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, 2012 and December 31, 2011, the Corporation had \$791,000 and \$794,000, respectively, of loans classified as TDRs, which are included in impaired loans above. At September 30, 2012 and December 31, 2011, the Corporation had \$36,000 and \$35,000, respectively, of the allowance for loan losses allocated to these specific loans.

During the nine month period ended September 30, 2012, the Corporation did not modify any additional loans as TDRs.

During the nine month period ended September 30, 2012, 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.

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

**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 future 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 anticipate probable incurred losses in the portfolios.

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

Management uses the following definitions for risk ratings:

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

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

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

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

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

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, 2012 and December 31, 2011:

(Dollar amounts in thousands)

|                                 | Not Rated | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---------------------------------|-----------|-----------|--------------------|-------------|----------|-----------|
| September 30, 2012:             |           |           |                    |             |          |           |
| Residential first mortgages     | \$95,570  | \$-       | \$-                | \$ 461      | \$ -     | \$96,031  |
| Home equity and lines of credit | 80,516    | -         | -                  | 119         | -        | 80,635    |
| Commercial real estate          | -         | 87,006    | 3,736              | 5,952       | 92       | 96,786    |
| Commercial business             | -         | 49,370    | 686                | 735         | -        | 50,791    |
| Consumer                        | 10,499    | -         | -                  | 1,712       | -        | 12,211    |
| Total                           | \$186,585 | \$136,376 | \$4,422            | \$8,979     | \$92     | \$336,454 |
| December 31, 2011:              |           |           |                    |             |          |           |
| Residential first mortgages     | \$92,612  | \$-       | \$-                | \$998       | \$-      | \$93,610  |
| Home equity and lines of credit | 71,064    | -         | -                  | 174         | -        | 71,238    |
| Commercial real estate          | -         | 88,006    | 3,625              | 3,134       | -        | 94,765    |
| Commercial business             | -         | 41,864    | 832                | 1,130       | -        | 43,826    |
| Consumer                        | 10,737    | -         | -                  | 1,905       | -        | 12,642    |
| Total                           | \$174,413 | \$129,870 | \$4,457            | \$7,341     | \$-      | \$316,081 |

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 non-performing loans as of September 30, 2012 and December 31, 2011:

(Dollar amounts in thousands)

|                                 | Performing                        |                                    |                                    | Nonperforming                     |            | Total<br>Loans |
|---------------------------------|-----------------------------------|------------------------------------|------------------------------------|-----------------------------------|------------|----------------|
|                                 | Accruing<br>Loans Not<br>Past Due | Accruing<br>30-59 Days<br>Past Due | Accruing<br>60-89 Days<br>Past Due | Accruing<br>90 Days +<br>Past Due | Nonaccrual |                |
| September 30, 2012:             |                                   |                                    |                                    |                                   |            |                |
| Residential first mortgages     | \$93,919                          | \$1,198                            | \$453                              | \$-                               | \$461      | \$96,031       |
| Home equity and lines of credit | 79,951                            | 375                                | 164                                | -                                 | 145        | 80,635         |
| Commercial real estate          | 92,067                            | 58                                 | -                                  | -                                 | 4,661      | 96,786         |
| Commercial business             | 49,996                            | 406                                | 15                                 | -                                 | 374        | 50,791         |

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|             |           |          |        |      |          |           |
|-------------|-----------|----------|--------|------|----------|-----------|
| Consumer    | 10,438    | 59       | 2      | -    | 1,712    | 12,211    |
| Total loans | \$326,371 | \$ 2,096 | \$ 634 | \$ - | \$ 7,353 | \$336,454 |

December 31, 2011:

|                                 |           |          |        |       |          |           |
|---------------------------------|-----------|----------|--------|-------|----------|-----------|
| Residential first mortgages     | \$91,400  | \$ 1,059 | \$ 153 | \$ 66 | \$ 932   | \$93,610  |
| Home equity and lines of credit | 70,506    | 431      | 127    | -     | 174      | 71,238    |
| Commercial real estate          | 92,632    | 302      | -      | -     | 1,831    | 94,765    |
| Commercial business             | 43,338    | 7        | 10     | -     | 471      | 43,826    |
| Consumer                        | 10,488    | 55       | 8      | -     | 2,091    | 12,642    |
| Total loans                     | \$308,364 | \$ 1,854 | \$ 298 | \$ 66 | \$ 5,499 | \$316,081 |

## 6. 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, 2012 and December 31, 2011:

(Dollar amounts in thousands)

|                                 | Not<br>Past Due | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days +<br>Past Due | Total<br>Loans |
|---------------------------------|-----------------|------------------------|------------------------|-----------------------|----------------|
| September 30, 2012:             |                 |                        |                        |                       |                |
| Residential first mortgages     | \$ -            | \$ -                   | \$ -                   | \$ 461                | \$461          |
| Home equity and lines of credit | -               | -                      | 26                     | 119                   | 145            |
| Commercial real estate          | 4,283           | -                      | 11                     | 367                   | 4,661          |
| Commercial business             | 83              | -                      | -                      | 291                   | 374            |
| Consumer                        | 1,712           | -                      | -                      | -                     | 1,712          |
| Total loans                     | \$ 6,078        | \$ -                   | \$ 37                  | \$ 1,238              | \$7,353        |
| December 31, 2011:              |                 |                        |                        |                       |                |
| Residential first mortgages     | \$ -            | \$ -                   | \$ -                   | \$ 932                | \$932          |
| Home equity and lines of credit | -               | -                      | -                      | 174                   | 174            |
| Commercial real estate          | 1,087           | 92                     | -                      | 652                   | 1,831          |
| Commercial business             | 471             | -                      | -                      | -                     | 471            |
| Consumer                        | 2,091           | -                      | -                      | -                     | 2,091          |
| Total loans                     | \$ 3,649        | \$ 92                  | \$ -                   | \$ 1,758              | \$5,499        |

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 non-performing 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.

**6. 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 Equity<br>& Lines<br>of Credit | Commercial<br>Real Estate | Commercial<br>Business | Commercial<br>Consumer | Total   |
|---|--------------------------|-------------------------------------|---------------------------|------------------------|------------------------|---------|
| Three months ended September 30, 2012:    |                          |                                     |                           |                        |                        |         |
| Allowance for loan losses:                |                          |                                     |                           |                        |                        |         |
| Beginning Balance                         | \$ 852                   | \$ 468                              | \$ 1,835                  | \$ 496                 | \$ 64                  | \$3,715 |
| Charge-offs                               | (13 )                    | -                                   | -                         | (5 )                   | (41 )                  | (59 )   |
| Recoveries                                | 1                        | -                                   | 1                         | -                      | 6                      | 8       |
| Provision                                 | (26 )                    | 104                                 | 1,229                     | 12                     | 40                     | 1,359   |
| Ending Balance                            | \$ 814                   | \$ 572                              | \$ 3,065                  | \$ 503                 | \$ 69                  | \$5,023 |
| Nine months ended September 30, 2012:     |                          |                                     |                           |                        |                        |         |
| Allowance for loan losses:                |                          |                                     |                           |                        |                        |         |
| Beginning Balance                         | \$ 832                   | \$ 320                              | \$ 1,737                  | \$ 590                 | \$ 57                  | \$3,536 |
| Charge-offs                               | (78 )                    | (40 )                               | (36 )                     | (14 )                  | (79 )                  | (247 )  |
| Recoveries                                | 84                       | 27                                  | 5                         | 15                     | 16                     | 147     |
| Provision                                 | (24 )                    | 265                                 | 1,359                     | (88 )                  | 75                     | 1,587   |
| Ending Balance                            | \$ 814                   | \$ 572                              | \$ 3,065                  | \$ 503                 | \$ 69                  | \$5,023 |
| At September 30, 2012:                    |                          |                                     |                           |                        |                        |         |
| Ending ALL balance attributable to loans: |                          |                                     |                           |                        |                        |         |
| Individually evaluated for impairment     | -                        | -                                   | 1,579                     | -                      | -                      | 1,579   |
| Collectively evaluated for impairment     | 814                      | 572                                 | 1,486                     | 503                    | 69                     | 3,444   |
| Total loans:                              |                          |                                     |                           |                        |                        |         |
| Individually evaluated for impairment     | -                        | -                                   | 4,661                     | 374                    | 1,712                  | 6,747   |
| Collectively evaluated for impairment     | 96,031                   | 80,635                              | 92,125                    | 50,417                 | 10,499                 | 329,707 |
| At December 31, 2011:                     |                          |                                     |                           |                        |                        |         |
| Ending ALL balance attributable to loans: |                          |                                     |                           |                        |                        |         |
| Individually evaluated for impairment     | -                        | -                                   | 22                        | 142                    | -                      | 164     |
| Collectively evaluated for impairment     | 832                      | 320                                 | 1,715                     | 448                    | 57                     | 3,372   |
| Total loans:                              |                          |                                     |                           |                        |                        |         |
| Individually evaluated for impairment     | -                        | -                                   | 1,678                     | 460                    | 1,905                  | 4,043   |
| Collectively evaluated for impairment     | 93,610                   | 71,238                              | 93,087                    | 43,366                 | 10,737                 | 312,038 |



Three months ended September 30,  
2011:

Allowance for loan losses:

|                   |        |        |          |          |       |          |
|-------------------|--------|--------|----------|----------|-------|----------|
| Beginning Balance | \$ 493 | \$ 207 | \$ 1,653 | \$ 1,166 | \$ 43 | \$ 3,562 |
| Charge-offs       | (39 )  | (34 )  | -        | (37 )    | (16 ) | (126 )   |
| Recoveries        | -      | 1      | -        | 5        | 3     | 9        |
| Provision         | 360    | 150    | 30       | (489 )   | 29    | 80       |
| Ending Balance    | \$ 814 | \$ 324 | \$ 1,683 | \$ 645   | \$ 59 | \$ 3,525 |

Nine months ended September 30,  
2011:

Allowance for loan losses:

|                   |        |        |          |          |        |          |
|-------------------|--------|--------|----------|----------|--------|----------|
| Beginning Balance | \$ 398 | \$ 572 | \$ 1,707 | \$ 1,323 | \$ 132 | \$ 4,132 |
| Charge-offs       | (220 ) | (161 ) | (200 )   | (355 )   | (41 )  | (977 )   |
| Recoveries        | -      | 1      | -        | 40       | 9      | 50       |
| Provision         | 636    | (88 )  | 176      | (363 )   | (41 )  | 320      |
| Ending Balance    | \$ 814 | \$ 324 | \$ 1,683 | \$ 645   | \$ 59  | \$ 3,525 |

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

## 7. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of September 30, 2012 and December 31, 2011:

| (Dollar amounts in thousands) | September 30, 2012    |                          | December 31, 2011     |                          |
|-------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                               | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Goodwill                      | \$ 3,664              | \$ -                     | \$ 3,664              | \$ -                     |
| Core deposit intangibles      | 4,027                 | 2,719                    | 4,027                 | 2,447                    |
| Total                         | \$ 7,691              | \$ 2,719                 | \$ 7,691              | \$ 2,447                 |

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. No goodwill impairment charges were recorded during 2011 or in the first nine months of 2012. The core deposit intangible asset is amortized using the double declining balance method over a weighted average estimated life of nine years and is not estimated to have a significant residual value. During the three and nine month periods ending September 30, 2012, the Corporation recorded intangible amortization expense totaling \$86,000 and \$272,000, respectively.

## 8. Stock Compensation Plans

The Corporation's 2007 Stock Incentive Plan and Trust (the Plan), which was approved by shareholders, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock. Incentive stock options, non-incentive or compensatory stock options and share awards may be granted under the Plan. The exercise price of each option shall at least equal the market price of a share of common stock on the date of grant and have a contractual term of up to 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 or liability instruments issued.

A summary of option activity under the Plan as of September 30, 2012, and changes during the period then ended is presented below:

| Options | Weighted-Average Exercise Price | Aggregate Intrinsic Value (in thousands) | Weighted-Average Remaining Term (in years) |
|---------|---------------------------------|--|--|
|---------|---------------------------------|--|--|

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|                                      |          |          |       |     |
|--------------------------------------|----------|----------|-------|-----|
| Outstanding as of January 1, 2012    | 94,000   | \$ 24.51 | \$ -  | 6.0 |
| Granted                              | -        | -        | -     | -   |
| Exercised                            | -        | -        | -     | -   |
| Forfeited                            | (1,750 ) | 15.00    | -     | -   |
| Outstanding as of September 30, 2012 | 92,250   | \$ 24.69 | \$ 34 | 5.2 |
| Exercisable as of September 30, 2012 | 84,000   | \$ 25.66 | \$ -  | 4.9 |

A summary of the status of the Corporation's nonvested option shares as of September 30, 2012, and changes during the period then ended is presented below:

|                                    | Options  | Weighted-Average<br>Grant-date Fair Value |
|------------------------------------|----------|---|
| Nonvested at January 1, 2012       | 10,000   | \$ 2.07                                   |
| Granted                            | -        | -   |
| Vested                             | -        | -   |
| Forfeited                          | (1,750 ) | 2.14                                      |
| Nonvested as of September 30, 2012 | 8,250    | \$ 2.06                                   |

## 8. Stock Compensation Plans (continued)

A summary of the status of the Corporation's nonvested restricted stock awards as of September 30, 2012, and changes during the period then ended is presented below:

|                                    | Shares | Weighted-Average<br>Grant-date Fair Value |
|------------------------------------|--------|---|
| Nonvested at January 1, 2012       | 22,500 | \$ 15.07                                  |
| Granted                            | 1,450  | 16.44                                     |
| Vested                             | -      | -   |
| Forfeited                          | -      | -   |
| Nonvested as of September 30, 2012 | 23,950 | \$ 15.15                                  |

For the three and nine month periods ended September 30, 2012, the Corporation recognized \$31,000 and \$92,000, respectively, in stock compensation expense, compared to \$14,000 and \$71,000, respectively, for the same periods in 2011. As of September 30, 2012, there was \$162,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next 2.4 years.

## 9. Fair Value

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

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

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

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

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

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

*Cash and cash equivalents* – The carrying value of cash, 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 and federal agency 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).

*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.

## 9. 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. 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, 2012 the fair value consists of loan balances of \$4.1 million, net of a valuation allowance of \$1.6 million, compared to loan balances of \$652,000, net of a valuation allowance of \$164,000 at December 31, 2011. There was \$1.4 million and \$1.5 million of additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2012. There was no additional provision recorded for impaired loans for the same periods in 2011.

*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, 2012 and December 31, 2011, OREO measured at fair value less costs to sell had a net carrying amount of \$45,000, which was made up of the outstanding balance of \$50,000 and a write-down of \$5,000. At September 30, 2011, OREO measured at fair value less costs to sell had a net carrying amount of \$14,000, which was made up of the outstanding balance of \$19,000 and a write-down of \$5,000.

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.

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

**9. Fair Value (continued)**

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

| (Dollar amounts in thousands)                    |           | (Level 1)   | (Level 2)                                    | (Level 3)                             |
|--|-----------|---|--|---------------------------------------|
| Description                                      | Total     | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
| September 30, 2012:                              |           |   |  |                                       |
| U.S. Treasury and federal agency                 | \$3,981   | \$ 3,981  | \$ -   | \$ -                                  |
| U.S. government sponsored entities and agencies  | 44,966    | -   | 44,966                                       | -                                     |
| Mortgage-backed securities: residential          | 25,175    | -   | 25,175                                       | -                                     |
| Collateralized mortgage obligations: residential | 26,167    | -   | 26,167                                       | -                                     |
| State and political subdivision                  | 37,399    | -   | 37,399                                       | -                                     |
| Corporate securities                             | 3,758     | -   | 3,758  | -                                     |
| Equity securities                                | 2,175     | 1,522   | -  | 653                                   |
|  | \$143,621 | \$ 5,503  | \$ 137,465                                   | \$ 653                                |
| December 31, 2011:                               |           |   |  |                                       |
| U.S. Treasury and federal agency                 | \$4,460   | \$ 4,460  | \$ -   | \$ -                                  |
| U.S. government sponsored entities and agencies  | 41,520    | -   | 41,520                                       | -                                     |
| Mortgage-backed securities: residential          | 37,478    | -   | 37,478                                       | -                                     |
| State and political subdivision                  | 37,000    | -   | 37,000                                       | -                                     |
| Equity securities                                | 2,696     | 1,052   | 1,644  | -                                     |
|  | \$123,154 | \$ 5,512  | \$ 117,642                                   | \$ -                                  |

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, 2012, the Corporation had no transfers between Level 1 and Level 2 and one transfer between Level 2 and Level 3. Transfers into Level 3 during the periods reflected transfers from Level 2 of certain equity securities due to reduced transparency of market prices as a result of less market activity in these instruments. The following table presents changes in Level 3 assets measured on a recurring basis for the three and nine month periods ended September 30, 2012 and 2011:

| (Dollar amounts in thousands)                | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|--|-------------------------------------|------|------------------------------------|------|
|  | 2012                                | 2011 | 2012                               | 2011 |
| Balance at the beginning of the period       | \$ -                                | \$ - | \$ -                               | \$ - |
| Total gains or losses (realized/unrealized): | -                                   | -    | -                                  | -    |



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|  |        |      |        |      |
|--|--------|------|--------|------|
| Included in earnings                   | -      | -    | -      | -    |
| Included in other comprehensive income | -      | -    | -      | -    |
| Issuances                              | -      | -    | -      | -    |
| Transfers in and/or out of Level 3     | 653    | -    | 653    | -    |
| Balance at the end of the period       | \$ 653 | \$ - | \$ 653 | \$ - |

**9. Fair Value (continued)**

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

| (Dollar amounts in thousands)         |         | (Level 1)<br>Quoted Prices in<br>Active Markets<br>for Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|---------------------------------------|---------|--|---|--|
| Description                           | Total   |  |   |  |
| September 30, 2012:                   |         |  |   |  |
| Impaired commercial real estate loans | \$2,557 | \$ -   | \$ -  | \$ 2,557   |
| Other residential real estate owned   | 45      | -  | -   | 45   |
|                                       | \$2,602 | \$ -   | \$ -  | \$ 2,602   |
| December 31, 2011:                    |         |  |   |  |
| Impaired commercial real estate loans | \$382   | \$ -   | \$ -  | \$ 382   |
| Impaired commercial business loans    | 106     | -  | -   | 106  |
| Other residential real estate owned   | 45      | -  | -   | 45   |
|                                       | \$533   | \$ -   | \$ -  | \$ 533   |

The following table presents quantitative information about Level 3 fair value measurements for assets measured at fair value on a non-recurring basis as of September 30, 2012:

| (Dollar amounts in thousands)         | September<br>30,<br>2012 | Valuation<br>Techniques(s)  | Unobservable<br>Input (s)<br>Adjustment for<br>differences   | Range         |
|---------------------------------------|--------------------------|---|--|---------------|
| Impaired commercial real estate loans | \$ 2,557                 | Sales comparison approach/<br>Contractual provision of<br>USDA loan | Adjustment for<br>differences<br>between comparable<br>sales | 10% -<br>100% |
| Other residential real estate owned   | 45                       | Sales comparison approach   | Adjustment for<br>differences<br>between comparable<br>sales | 10%           |

Included in impaired commercial real estate loans is a \$356,000 loan guaranteed by the United States Department of Agriculture (USDA). The guarantee covers 90% of the principal balance outstanding. In determining the fair value of this loan, the Corporation considered the contractual provisions of the loan and did not rely on the fair value of the underlying collateral. As such, the Corporation applied a 10% discount to the loan which represents the portion of the

loan at risk. Also included in impaired commercial real estate loans are two impaired commercial real estate loans totaling \$95,000 which were discounted by 100% due to uncertainties surrounding possible bankruptcy court outcomes regarding the Corporation's collateral lien position. The weighted average discount on impaired commercial real estate loans as of September 30, 2012 was 13%.

**9. Fair Value (continued)**

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of September 30, 2012 and December 31, 2011:

| Description                   | Carrying Amount | Fair Value Measurements at September 30, 2012 using: |          |         |         |
|-------------------------------|-----------------|--|----------|---------|---------|
|                               |                 | Total  | Level 1  | Level 2 | Level 3 |
| September 30, 2012:           |                 |  |          |         |         |
| Financial Assets:             |                 |  |          |         |         |
| Cash and cash equivalents     | \$23,027        | \$23,027   | \$23,027 | \$-     | \$-     |
| Securities available for sale | 143,621         | 143,621  | 5,503    | 137,465 | 653     |
| Loans, net                    | 331,431         | 337,652  | -        | -       | 337,652 |
| Federal bank stock            | 3,171           | N/A  | -        | -       | -       |
| Accrued interest receivable   | 1,736           | 1,736  | 5        | 584     | 1,147   |
|                               | 502,986         | 506,036  | 28,535   | 138,049 | 339,452 |
| Financial Liabilities:        |                 |  |          |         |         |
| Deposits                      | 453,497         | 458,617  | 317,593  | 141,024 | -       |
| FHLB advances                 | 20,000          | 23,241   | -        | 23,241  | -       |
| Accrued interest payable      | 516             | 516  | 59       | 457     | -       |
|                               | 474,013         | 482,374  | 317,652  | 164,722 | -       |
| December 31, 2011:            |                 |  |          |         |         |
| Financial Assets:             |                 |  |          |         |         |
| Cash and cash equivalents     | 28,193          | 28,193   |          |         |         |
| Securities available for sale | 123,154         | 123,154  |          |         |         |
| Loans, net                    | 312,545         | 319,967  |          |         |         |
| Federal bank stock            | 3,664           | N/A  |          |         |         |
| Accrued interest receivable   | 1,630           | 1,630  |          |         |         |
|                               | 469,186         | 472,944  |          |         |         |
| Financial Liabilities:        |                 |  |          |         |         |
| Deposits                      | 416,468         | 422,704  |          |         |         |
| FHLB advances                 | 20,000          | 23,362   |          |         |         |
| Accrued interest payable      | 541             | 541  |          |         |         |
|                               | 437,009         | 446,607  |          |         |         |

**10. New Accounting Standards**

In May 2011, the Financial Accounting Standards Board (FASB) issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International account principles. Overall the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The

amendments in this guidance are effective for the interim and annual reporting periods beginning after December 15, 2011. This guidance did not have a material impact on the Corporation's consolidated financial statements.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective as of the beginning of a fiscal reporting year, and interim periods within that year, that begins after December 15, 2011. The adoption of this amendment changed the presentation of comprehensive income for the Corporation.

## **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, the Bank and the Title Company, for the three and nine months ended September 30, 2012, compared to the same periods in 2011 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 21 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 \$38.3 million or 7.8% to \$530.2 million at September 30, 2012 from \$491.9 million at December 31, 2011. This increase resulted primarily from increases in securities and loans receivable of \$20.5 million and \$18.9 million, respectively, which was funded by an increase in customer deposits of \$37.0 million.

Total liabilities increased \$36.9 million or 8.4% to \$478.0 million at September 30, 2012 from \$441.2 million at December 31, 2011, resulting primarily from the aforementioned \$37.0 million increase in customer deposits which consisted of a \$17.9 million or 21.1% increase in noninterest bearing deposits and a \$19.1 million or 5.8% increase in interest bearing deposits.

Stockholders' equity increased \$1.4 million or 2.8% to \$52.2 million at September 30, 2012 from \$50.7 million at December 31, 2011. Book value and tangible book value per common share was \$24.07 and \$21.23, respectively, at

September 30, 2012, compared to \$23.25 and \$20.26, respectively, at December 31, 2011.

At September 30, 2012, the Bank was considered well capitalized under regulatory guidelines with a Tier 1 leverage ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.46%, 14.72% and 15.97%, respectively, compared to 8.69%, 15.00% and 16.25%, respectively, at December 31, 2011.

## RESULTS OF OPERATIONS

Comparison of Results for the Three Month Period Ended September 30, 2012 and 2011

**General.** Net income before preferred stock dividends and discount accretion decreased \$380,000 or 36.2% to \$669,000 for the three months ended September 30, 2012 from \$1.0 million for the same period in 2011. This decrease was the result of a \$1.3 million increase in the provision for loan losses, partially offset by increases in net interest income and noninterest income of \$166,000 and \$548,000, respectively, and decreases in noninterest expense and the provision for income taxes of \$38,000 and \$147,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis increased \$169,000 or 4.1% to \$4.3 million for the three months ended September 30, 2012 from \$4.1 million for the same period in 2011. This increase can be attributed to a decrease in interest expense of \$207,000, partially offset by a decrease in tax equivalent interest income of \$38,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$38,000 to \$5.5 million for the three months ended September 30, 2012 as compared to \$5.6 million for the three months ended September 30, 2011. This decrease can be attributed to decreases in interest on securities and interest-earning deposits with banks of \$83,000 and \$23,000, respectively, partially offset by increases in interest earned on loans and federal bank stocks of \$66,000 and \$2,000.

Tax equivalent interest earned on securities decreased \$83,000 or 7.5% to \$1.0 million for the three months ended September 30, 2012 as compared to \$1.1 million for the three months ended September 30, 2011. This decrease resulted from a decrease in the yield on securities of 72 basis points to 2.64% for the three months ended September 30, 2012, versus 3.36% for the same period in 2011, due primarily to calls of higher-yielding securities. This unfavorable yield variance accounted for a \$264,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average securities increased \$23.7 million or 18.2%, accounting for an \$181,000 increase in interest income.

Interest earned on interest-earning deposit accounts decreased \$23,000 or 57.5% to \$17,000 for the three months ended September 30, 2012 from \$40,000 for the same period in 2011. This decrease resulted from a decrease in the average yield on interest-earning deposit accounts of 34 basis points to 0.39% for the three months ended September 30, 2012, compared to 0.73% for the same period in the prior year, accounting for a \$16,000 decrease in interest income. In addition to this unfavorable yield variance, the average balance of these assets decreased \$4.8 million, accounting for a \$7,000 decrease in interest income.

Tax equivalent interest earned on loans receivable increased \$66,000 to \$4.5 million for the three months ended September 30, 2012 as compared to \$4.4 million for the three months ended September 30, 2011. This increase resulted as average loans increased \$22.3 million or 7.2%, accounting for an increase of \$306,000 in loan interest income. Partially offsetting this favorable volume variance, the average yield on loans receivable decreased 29 basis points to 5.33% for the three months ended September 30, 2012, versus 5.62% for the same period in 2011. This unfavorable yield variance accounted for a \$240,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$207,000 or 14.3% to \$1.2 million for the three months ended September 30, 2012 from \$1.5 million for the same period in 2011. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$170,000 and \$37,000, respectively.

Interest expense incurred on deposits decreased \$170,000 or 14.4% to \$1.0 million for the three months ended September 30, 2012 compared to \$1.2 million for the same period in 2011. The average cost of interest-bearing deposits decreased 28 basis points to 1.13% for the three months ended September 30, 2012, compared to 1.41% for the same period in 2011 resulting in a \$252,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during 2011 and the first nine months of 2012 in the overall low interest-rate environment. Partially offsetting this favorable rate variance, the average balance of interest-bearing deposits



increased \$24.3 million to \$354.7 million for the three months ended September 30, 2012, compared to \$330.5 million for the same period in 2011 causing an \$82,000 increase in interest expense.

Interest expense incurred on borrowed funds decreased \$37,000 or 13.5% to \$238,000 for the three months ended September 30, 2012, compared to \$275,000 for the same period in the prior year. The average balance of borrowed funds decreased \$4.1 million or 17.1%, accounting for a \$48,000 decrease in interest expense. Partially offsetting this favorable volume variance, the average cost of borrowed funds increased 21 basis points to 4.72% for the three months ended September 30, 2012, compared to 4.51% for the same period in 2011, causing a \$11,000 increase in interest expense. Both the decrease in volume and increase in rate were primarily related to the Corporation's repayment of a \$5.0 million credit line at a correspondent bank during the third quarter of 2011.

**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 non-accrual 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, |          |                 |      |                    |          |                 |
|--------------------------------------|----------------------------------|----------|-----------------|------|--------------------|----------|-----------------|
|                                      | 2012                             |          |                 | 2011 |                    |          |                 |
|                                      | Average<br>Balance               | Interest | Yield /<br>Rate |      | Average<br>Balance | Interest | Yield /<br>Rate |
| Interest-earning assets:             |                                  |          |                 |      |                    |          |                 |
| Loans, taxable                       | \$311,238                        | \$4,222  | 5.40 %          |      | \$298,993          | \$4,238  | 5.62 %          |
| Loans, tax exempt                    | 21,333                           | 236      | 4.40 %          |      | 11,261             | 154      | 5.43 %          |
| Total loans receivable               | 332,571                          | 4,458    | 5.33 %          |      | 310,254            | 4,392    | 5.62 %          |
| Securities, taxable                  | 117,783                          | 617      | 2.08 %          |      | 93,922             | 643      | 2.72 %          |
| Securities, tax exempt               | 36,620                           | 407      | 4.42 %          |      | 36,740             | 464      | 5.01 %          |
| Total securities                     | 154,403                          | 1,024    | 2.64 %          |      | 130,662            | 1,107    | 3.36 %          |
| Interest-earning deposits with banks | 17,561                           | 17       | 0.39 %          |      | 21,808             | 40       | 0.73 %          |
| Federal bank stocks                  | 3,249                            | 15       | 1.84 %          |      | 3,790              | 13       | 1.36 %          |
| Total interest-earning other assets  | 20,810                           | 32       | 0.61 %          |      | 25,598             | 53       | 0.82 %          |
| Total interest-earning assets        | 507,784                          | 5,514    | 4.32 %          |      | 466,514            | 5,552    | 4.72 %          |
| Cash and due from banks              | 2,322                            |          |                 |      | 2,629              |          |                 |
| Other noninterest-earning assets     | 23,377                           |          |                 |      | 21,617             |          |                 |
| Total Assets                         | \$533,483                        |          |                 |      | \$490,760          |          |                 |
| Interest-bearing liabilities:        |                                  |          |                 |      |                    |          |                 |
| Interest-bearing demand deposits     | \$217,864                        | \$125    | 0.23 %          |      | \$178,786          | \$114    | 0.25 %          |
| Time deposits                        | 136,882                          | 883      | 2.57 %          |      | 151,707            | 1,064    | 2.78 %          |
| Total interest-bearing deposits      | 354,746                          | 1,008    | 1.13 %          |      | 330,493            | 1,178    | 1.41 %          |
| Borrowed funds, short-term           | 43                               | -        | 0.00 %          |      | 4,168              | 39       | 3.71 %          |
| Borrowed funds, long-term            | 20,000                           | 238      | 4.73 %          |      | 20,000             | 236      | 4.68 %          |
| Total borrowed funds                 | 20,043                           | 238      | 4.72 %          |      | 24,168             | 275      | 4.51 %          |
| Total interest-bearing liabilities   | 374,789                          | 1,246    | 1.32 %          |      | 354,661            | 1,453    | 1.63 %          |
| Noninterest-bearing demand deposits  | 101,304                          | -        | -               |      | 85,219             | -        | -               |
| Funding and cost of funds            | 476,093                          | 1,246    | 1.04 %          |      | 439,880            | 1,453    | 1.31 %          |

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|  |           |         |           |         |
|--|-----------|---------|-----------|---------|
| Other noninterest-bearing liabilities  | 5,004     |         | 3,533     |         |
| Total Liabilities  | 481,097   |         | 443,413   |         |
| Stockholders' Equity   | 52,386    |         | 47,347    |         |
| Total Liabilities and Stockholders' Equity   | \$533,483 |         | \$490,760 |         |
| Net interest income  |           | \$4,268 |           | \$4,099 |
| <b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) |           |         | 3.00 %    | 3.09 %  |
| <b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)                                |           |         | 3.34 %    | 3.49 %  |

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

| (Dollar amounts in thousands)             | Three months ended September 30,<br>2012 versus 2011<br>Increase (Decrease) due to |                  |               |
|---|--|------------------|---------------|
|   | Volume   | Rate             | Total         |
| <b>Interest income:</b>                   |  |                  |               |
| Loans                                     | \$ 306   | \$ (240 )        | \$ 66         |
| Securities                                | 181  | (264 )           | (83 )         |
| Interest-earning deposits with banks      | (7 )   | (16 )            | (23 )         |
| Federal bank stocks                       | (2 )   | 4                | 2             |
| <b>Total interest-earning assets</b>      | <b>478</b>   | <b>(516 )</b>    | <b>(38 )</b>  |
| <b>Interest expense:</b>                  |  |                  |               |
| Interest-bearing deposits                 | 82   | (252 )           | (170 )        |
| Borrowed funds                            | (48 )  | 11               | (37 )         |
| <b>Total interest-bearing liabilities</b> | <b>34</b>  | <b>(241 )</b>    | <b>(207 )</b> |
| <b>Net interest income</b>                | <b>\$ 444</b>  | <b>\$ (275 )</b> | <b>\$ 169</b> |

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of non-performing 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 non-performing assets for the quarter ended September 30, 2012 and 2011 is as follows:

(Dollar amounts in thousands)

At or for the three months ended

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|   | September 30, |   |          |   |
|---|---------------|---|----------|---|
|   | 2012          |   | 2011     |   |
| Balance at the beginning of the period            | \$ 3,715      |   | \$ 3,562 |   |
| Provision for loan losses                         | 1,359         |   | 80       |   |
| Charge-offs                                       | (59 )         |   | (126 )   |   |
| Recoveries  | 8             |   | 9        |   |
| Balance at the end of the period                  | \$ 5,023      |   | \$ 3,525 |   |
| <br>  |               |   |          |   |
| Non-performing loans                              | \$ 7,353      |   | \$ 5,269 |   |
| Non-performing assets                             | 7,656         |   | 5,624    |   |
| Non-performing loans to total loans               | 2.19          | % | 1.70     | % |
| Non-performing assets to total assets             | 1.44          | % | 1.14     | % |
| Allowance for loan losses to total loans          | 1.49          | % | 1.14     | % |
| Allowance for loan losses to non-performing loans | 68.31         | % | 66.90    | % |

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Nonperforming loans increased \$2.1 million to \$7.4 million at September 30, 2012 from \$5.3 million at September 30, 2011. The increase in nonperforming loans was primarily due to a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 based on information received during the quarter on current cash flow considerations, weakened financial condition of the principals and guarantors and recent appraisal information. Partially offsetting this addition was the successful resolution and payoff of a \$450,000 nonperforming residential mortgage loan during the first quarter of 2012, an upgrade of a \$222,000 commercial relationship to accruing status and additional principal reductions resulting from other credit workouts and repayments. During the three months ended September 30, 2012, nonperforming loans increased by \$3.4 million to \$7.4 million from \$3.9 million at June 30, 2012.

As of September 30, 2012, the Corporation's classified and criticized assets amounted to \$13.5 million or 2.5% of total assets, with \$9.0 million classified as substandard, \$4.4 million identified as special mention and \$92,000 classified as doubtful. This compares to classified and criticized assets of \$12.0 million or 2.4% of total assets, with \$8.0 million classified as substandard and \$3.9 million identified as special mention at September 30, 2011. The increase in criticized and classified assets was primarily the result of the aforementioned \$3.4 million commercial real estate credit which was downgraded to special mention during the quarter ended June 30, 2012 and further downgraded to substandard during the quarter ended September 30, 2012, partially offset by credit workouts and principal payments.

The provision for loan losses increased \$1.3 million to \$1.4 million for the three month period ended September 30, 2012 from \$80,000 for the same period in the prior year primarily as \$1.4 million in specific reserves was allocated to the aforementioned \$3.4 million commercial credit relationship. The specific reserve was based on an appraisal report of the fair value of the real property at September 30, 2012, adjusted for estimated liquidation costs. The valuation may be impacted by future strategies employed by management to resolve this problem credit situation. The Corporation's historic loss factors have been favorably impacted due to low levels of net charge-offs during recent periods, offsetting the impact of loan growth on the provision for loan losses.

**Noninterest income.** Noninterest income increased \$548,000 or 66.4% to \$1.4 million during the three months ended September 30, 2012, compared to \$825,000 during the same period in the prior year. This increase was primarily due to increases in gains on the sale of securities and commissions on financial services of \$390,000 and \$66,000, respectively. During the third quarter of 2012, the Corporation recognized \$390,000 in gains related to the sale of \$5.4 million of mortgage-backed securities. The increase in commissions on financial services resulted from expansion in the financial service division to three representatives during the quarter ended September 30, 2012 from one representative during the quarter ended September 30, 2011.

**Noninterest expense.** Noninterest expense decreased \$38,000 or 1.1% at \$3.4 million during the three months ended September 30, 2012 and 2011. This decrease in noninterest expense can be attributed to decreases in compensation and benefits expense, professional fees, intangible amortization, FDIC insurance and premises and equipment expense of \$59,000, \$57,000, \$24,000, \$24,000 and \$21,000, respectively, partially offset by an increase in other noninterest expense of \$147,000.

Compensation and employee benefits expense decreased \$59,000 or 3.4% at \$1.7 million for the three months ended September 30, 2012 and 2011. This decrease can be primarily attributed to a \$265,000 reduction in employee incentive expense partially offset by normal salary and wage increases and increased employee benefit costs.

Professional fees decreased \$57,000 or 29.7% to \$135,000 for the three months ended September 30, 2012 from \$192,000 for the same period in the prior year. This decrease can be primarily attributed to a \$59,000 decrease in legal fees mainly related to declines in foreclosure and loan workout activity.

As a result of a branch purchase completed in the third quarter of 2009, the Corporation recognized \$86,000 of core deposit intangible amortization expense during the third quarter of 2012, compared to \$110,000 for the same period in the prior year. Further discussion related to goodwill and intangible assets related to the branch office purchase can be found in the "Notes to Consolidated Financial Statements" beginning on page 5.

FDIC insurance decreased \$24,000 or 20.7% to \$92,000 for the three months ended September 30, 2012, compared to \$116,000 for the same period in the prior year. This was the result of 2011 legislative changes that adjusted the assessment base, which reduced the assessment rate for the Bank and favorably impacted premium expense.

Premises and equipment expense decreased \$21,000 or 4.0% to \$509,000 for the three months ended September 30, 2012, compared to \$530,000 for the same period in the prior year. This decrease can be primarily attributed to a decrease of \$40,000 in depreciation expense.

Other noninterest expense increased \$147,000 or 20.7% to \$857,000 for the three months ended September 30, 2012, compared to \$710,000 for the same period in the prior year. This unfavorable variance can be attributed primarily to increased costs associated with debit card processing and a debit card reward program launched in the first quarter of 2012.

**Provision for income taxes.** The provision for income taxes decreased \$147,000 or 68.7% to \$67,000 for the three months ended September 30, 2012 compared to \$214,000 for the same period in the prior year, as the Corporation's effective tax rate decreased to 9.1% for the third quarter of 2012 from 22.0% from the same quarter in the prior year due to a decrease in taxable income, primarily from increased provision for loan losses during the quarter. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 9.1% for the quarter ended September 30, 2012, was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

#### Comparison of Results for the Nine Month Period Ended September 30, 2012 and 2011

**General.** Net income before preferred stock dividends and discount accretion increased \$283,000 or 10.6% to \$3.0 million for the nine months ended September 30, 2012 from \$2.7 million for the same period in 2011. This increase was the result of increases in net interest income and noninterest income of \$537,000 and \$1.0 million, respectively, and a decrease in noninterest expense of \$201,000. Partially offsetting these favorable items, the provision for loan losses and the provision for income taxes increased \$1.3 million and \$224,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis increased \$546,000 or 4.6% to \$12.5 million for the nine months ended September 30, 2012 from \$12.0 million for the same period in 2011. This increase can be attributed to a decrease in interest expense of \$697,000, partially offset by a decrease in tax equivalent interest income of \$151,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$151,000 to \$16.3 million for the nine months ended September 30, 2012 as compared to \$16.5 million for the nine months ended September 30, 2011. This decrease can be attributed to decreases in interest on securities and interest-earning deposits with banks of \$154,000 and \$73,000, respectively, partially offset by increases in interest earned on loans and federal bank stocks of \$69,000 and \$7,000.



Tax equivalent interest earned on securities decreased \$154,000 or 4.9% to \$3.0 million for the nine months ended September 30, 2012, compared to \$3.2 million for the nine months ended September 30, 2011. This decrease resulted from a decrease in the yield on securities of 51 basis points to 2.83% for the nine months ended September 30, 2012, versus 3.34% for the same period in 2011, due primarily to calls of higher-yielding securities. This unfavorable yield variance accounted for a \$510,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average securities increased \$15.3 million or 12.1%, accounting for a \$356,000 increase in interest income.

Interest earned on interest-earning deposit accounts decreased \$73,000 or 51.8% to \$68,000 for the nine months ended September 30, 2012 from \$141,000 for the same period in 2011. This decrease resulted from a decrease in the average yield on interest-earning deposit accounts of 35 basis points to 0.35% for the nine months ended September 30, 2012, compared to 0.70% for the same period in the prior year, accounting for a \$69,000 decrease in interest income. In addition, the average balance of these assets decreased \$794,000, primarily as excess cash was deployed into higher yielding securities and loans, accounting for a \$4,000 decrease in interest income.

Tax equivalent interest earned on loans receivable increased \$69,000 to \$13.2 million for the nine months ended September 30, 2012 as compared to \$13.1 million for the nine months ended September 30, 2011. This increase resulted as average loans increased \$18.9 million or 6.1%, accounting for an increase of \$783,000 in loan interest income. Partially offsetting this favorable volume variance, the average yield on loans receivable decreased 30 basis points to 5.40% for the nine months ended September 30, 2012, versus 5.70% for the same period in 2011. This unfavorable yield variance accounted for a \$714,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$697,000 or 15.5% to \$3.8 million for the nine months ended September 30, 2012 from \$4.5 million for the same period in 2011. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$456,000 and \$241,000, respectively.

Interest expense incurred on deposits decreased \$456,000 or 12.8% to \$3.1 million for the nine months ended September 30, 2012 compared to \$3.6 million for the same period in 2011. The average cost of interest-bearing deposits decreased 25 basis points to 1.18% for the nine months ended September 30, 2012, compared to 1.43% for the same period in 2011 resulting in a \$646,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during late 2011 and the first nine months of 2012 in the overall low interest-rate environment. Partially offsetting this favorable rate variance, the average balance of interest-bearing deposits increased \$18.4 million to \$350.4 million for the nine months ended September 30, 2012, compared to \$332.0 million for the same period in 2011 causing a \$190,000 increase in interest expense.

Interest expense incurred on borrowed funds decreased \$241,000 or 25.4% to \$707,000 for the nine months ended September 30, 2012, compared to \$948,000 for the same period in the prior year. The average balance of borrowed funds decreased \$7.3 million or 26.8%, accounting for a \$259,000 decrease in interest expense. Partially offsetting this favorable volume variance, the average cost of borrowed funds increased 8 basis points to 4.72% for the nine months ended September 30, 2012, compared to 4.64% for the same period in 2011, causing a \$18,000 increase in interest expense. Both the decrease in volume and increase in rate were primarily related to the Corporation's early retirement of \$5.0 million in long-term FHLB borrowings during second quarter of 2011, and the repayment of a \$5.0 million credit line at a correspondent bank during the second and third quarter of 2011.

**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 non-accrual 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, |          |                 |                    |          |                 |
|---|---------------------------------|----------|-----------------|--------------------|----------|-----------------|
|   | 2012                            |          |                 | 2011               |          |                 |
|   | Average<br>Balance              | Interest | Yield /<br>Rate | Average<br>Balance | Interest | Yield /<br>Rate |
| Interest-earning assets:                |                                 |          |                 |                    |          |                 |
| Loans, taxable                          | \$305,774                       | \$12,504 | 5.46 %          | \$295,718          | \$12,659 | 5.72 %          |
| Loans, tax exempt                       | 20,834                          | 688      | 4.41 %          | 12,005             | 464      | 5.17 %          |
| Total loans receivable                  | 326,608                         | 13,192   | 5.40 %          | 307,723            | 13,123   | 5.70 %          |
| Securities, taxable                     | 105,010                         | 1,763    | 2.24 %          | 90,522             | 1,762    | 2.60 %          |
| Securities, tax exempt                  | 36,720                          | 1,239    | 4.51 %          | 35,929             | 1,394    | 5.19 %          |
| Total securities                        | 141,730                         | 3,002    | 2.83 %          | 126,451            | 3,156    | 3.34 %          |
| Interest-earning deposits with banks    | 26,074                          | 68       | 0.35 %          | 26,869             | 141      | 0.70 %          |
| Federal bank stocks                     | 3,434                           | 46       | 1.79 %          | 3,928              | 39       | 1.33 %          |
| Total interest-earning cash equivalents | 29,508                          | 114      | 0.52 %          | 30,797             | 180      | 0.78 %          |
| Total interest-earning assets           | 497,846                         | 16,308   | 4.38 %          | 464,971            | 16,459   | 4.73 %          |
| Cash and due from banks                 | 2,482                           |          |                 | 2,549              |          |                 |
| Other noninterest-earning assets        | 21,504                          |          |                 | 21,796             |          |                 |
| Total assets                            | \$521,832                       |          |                 | \$489,316          |          |                 |
| Interest-bearing liabilities:           |                                 |          |                 |                    |          |                 |
| Interest-bearing demand deposits        | \$209,540                       | \$350    | 0.22 %          | \$181,338          | \$380    | 0.28 %          |
| Time deposits                           | 140,882                         | 2,755    | 2.61 %          | 150,635            | 3,181    | 2.82 %          |
| Total interest-bearing deposits         | 350,422                         | 3,105    | 1.18 %          | 331,973            | 3,561    | 1.43 %          |
| Borrowed funds, long-term               | 20,000                          | 707      | 4.72 %          | 22,766             | 789      | 4.63 %          |
| Borrowed funds, short-term              | 15                              | -        | 0.00 %          | 4,564              | 159      | 4.66 %          |
| Total borrowed funds                    | 20,015                          | 707      | 4.72 %          | 27,330             | 948      | 4.64 %          |
| Total interest-bearing liabilities      | 370,437                         | 3,812    | 1.37 %          | 359,303            | 4,509    | 1.68 %          |
| Noninterest-bearing demand deposits     | 94,630                          | -        | -               | 82,414             | -        | -               |
| Funding and cost of funds               | 465,067                         | 3,812    | 1.09 %          | 441,717            | 4,509    | 1.36 %          |
| Other noninterest-bearing liabilities   | 5,044                           |          |                 | 3,764              |          |                 |

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|  |           |           |
|--|-----------|-----------|
| Total liabilities  | 470,111   | 445,481   |
| Stockholders' equity   | 51,721    | 43,835    |
| Total liabilities and stockholders' equity   | \$521,832 | \$489,316 |
| Net interest income  | \$12,496  | \$11,950  |
| <b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) | 3.01 %    | 3.05 %    |
| <b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)                                | 3.35 %    | 3.44 %    |

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

| (Dollar amounts in thousands)             | Nine months ended September 30,<br>2012 versus 2011 |                  |               |
|---|---|------------------|---------------|
|   | Increase (Decrease) due to                          |                  |               |
|   | Volume  | Rate             | Total         |
| <b>Interest income:</b>                   |   |                  |               |
| Loans                                     | \$ 783  | \$ (714 )        | \$ 69         |
| Securities                                | 356   | (510 )           | (154 )        |
| Interest-earning deposits with banks      | (4 )  | (69 )            | (73 )         |
| Federal bank stocks                       | (5 )  | 12               | 7             |
| <b>Total interest-earning assets</b>      | <b>1,130</b>  | <b>(1,281 )</b>  | <b>(151 )</b> |
| <b>Interest expense:</b>                  |   |                  |               |
| Deposits                                  | 190   | (646 )           | (456 )        |
| Borrowed funds                            | (259 )  | 18               | (241 )        |
| <b>Total interest-bearing liabilities</b> | <b>(69 )</b>  | <b>(628 )</b>    | <b>(697 )</b> |
| <b>Net interest income</b>                | <b>\$ 1,199</b>                                     | <b>\$ (653 )</b> | <b>\$ 546</b> |

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of non-performing 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 non-performing assets for the nine months ended September 30, 2012 and 2011 is as follows:

|                               |  |
|-------------------------------|--|
| (Dollar amounts in thousands) | At or for the nine months ended<br>September 30, |
|-------------------------------|--|

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|   | 2012     |   | 2011     |   |
|---|----------|---|----------|---|
| Balance at the beginning of the period            | \$ 3,536 |   | \$ 4,132 |   |
| Provision for loan losses                         | 1,587    |   | 320      |   |
| Charge-offs                                       | (247 )   |   | (977 )   |   |
| Recoveries  | 147      |   | 50       |   |
| Balance at the end of the period                  | \$ 5,023 |   | \$ 3,525 |   |
| Non-performing loans                              | \$ 7,353 |   | \$ 5,269 |   |
| Non-performing assets                             | 7,656    |   | 5,624    |   |
| Non-performing loans to total loans               | 2.19     | % | 1.70     | % |
| Non-performing assets to total assets             | 1.44     | % | 1.14     | % |
| Allowance for loan losses to total loans          | 1.49     | % | 1.14     | % |
| Allowance for loan losses to non-performing loans | 68.31    | % | 66.90    | % |

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Nonperforming loans increased \$2.1 million to \$7.4 million at September 30, 2012 from \$5.3 million at September 30, 2011. The increase in nonperforming loans was primarily due to a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 based on information received during the quarter on current cash flow considerations, weakened financial condition of the principals and guarantors and recent appraisal information. Partially offsetting this addition was the successful resolution and payoff of a \$450,000 nonperforming residential mortgage loan during the first quarter of 2012, an upgrade of a \$222,000 commercial relationship to accruing status and additional principal reductions resulting from other credit workouts and repayments. During the nine months ended September 30, 2012, nonperforming loans increased by \$1.8 million to \$7.4 million from \$5.9 million at December 31, 2011.

As of September 30, 2012, the Corporation's classified and criticized assets amounted to \$13.5 million or 2.5% of total assets, with \$9.0 million classified as substandard, \$4.4 million identified as special mention and \$92,000 classified as doubtful. This compares to classified and criticized assets of \$11.8 million or 2.4% of total assets, with \$7.3 million classified as substandard and \$4.5 million identified as special mention at December 31, 2011. The increase in criticized and classified assets was primarily the result of the aforementioned \$3.4 million commercial real estate credit which was downgraded to special mention during the quarter ended June 30, 2012 and further downgraded to substandard during the quarter ended September 30, 2012, partially offset by credit workouts and principal payments.

The provision for loan losses increased \$1.3 million to \$1.6 million for the nine month period ended September 30, 2012 from \$320,000 for the same period in the prior year as \$1.4 million in specific reserves was allocated to the aforementioned \$3.4 million commercial credit relationship. . The Corporation's historic loss factors have been favorably impacted due to low levels of net charge-offs during recent periods, offsetting the impact of loan growth on the provision for loan losses.

**Noninterest income.** Noninterest income increased \$1.0 million or 34.8% to \$4.0 million during the nine months ended September 30, 2012, compared to \$3.0 million during the same period in the prior year. This increase was primarily due to increases in gains on the sale of securities, other noninterest income and fees and service charges of \$870,000, \$125,000 and \$51,000, respectively. During the first nine months of 2012, the Corporation recognized \$424,000 in gains related to the sale of a community bank stock, \$538,000 in gains from the sale of U.S. Treasury securities, and \$390,000 in gains from the sale of mortgage-backed securities. Gains on the sale of securities during the first nine months of 2011 totaled \$482,000. The increase in other noninterest income resulted from increased interchange fee income while the increase in fees and service charges resulted from increased overdraft fees and paper statement and foreign ATM usage fees which were implemented during the third quarter of 2012.

**Noninterest expense.** Noninterest expense decreased \$201,000 or 1.9% to \$10.6 million during the nine months ended September 30, 2012, compared to \$10.8 million during the same period in 2011. This decrease in noninterest expense can be attributed to decreases in premises and equipment expense, FDIC insurance, intangible asset amortization and professional fees of \$141,000, \$132,000, \$76,000 and \$28,000, respectively, partially offset by increases in compensation and benefits expense, and other noninterest expense of \$120,000 and \$56,000, respectively.

Premises and equipment expense decreased \$141,000 or 8.5% to \$1.5 million for the nine months ended September 30, 2012, compared to \$1.7 million for the same period in the prior year. This decrease can be primarily attributed to decreases of \$100,000 and \$36,000, respectively, in depreciation and building maintenance costs.

FDIC insurance decreased \$132,000 or 31.9% to \$282,000 for the nine months ended September 30, 2012, compared to \$414,000 for the same period in the prior year. This was the result of 2011 legislative changes that adjusted the assessment base, which reduced the assessment rate for the Bank and favorably impacted premium expense.

As a result of a branch acquisition completed in the third quarter of 2009, the Corporation recognized \$272,000 of core deposit intangible amortization expense during the first nine months of 2012, compared to \$348,000 for the same period in the prior year. Further discussion related to goodwill and intangible assets related to the branch office purchase can be found in the "Notes to Consolidated Financial Statements" beginning on page 5.



Compensation and employee benefits expense increased \$120,000 or 2.2% to \$5.5 million for the nine months ended September 30, 2012, compared to \$5.4 million for the same period in the prior year. This increase can be primarily attributed to normal salary and wage increases and a \$71,000 expense related to post-retirement life insurance benefits.

Other noninterest expense increased \$56,000 or 2.3% to \$2.5 million for the nine months ended September 30, 2012, compared to \$2.4 million for the same period in the prior year. This unfavorable variance can be attributed primarily to increased costs associated with debit card processing and a debit card reward program launched in the first quarter of 2012, partially offset by nonrecurring prepayment penalties totaling \$334,000 assessed in connection with the early retirement of a \$5.0 million FHLB long-term borrowing during the nine months ended September 30, 2011.

**Provision for income taxes.** The provision for income taxes increased \$224,000 or 36.7% to \$835,000 for the nine months ended September 30, 2012 compared to \$611,000 for the same period in the prior year, as the Corporation's effective tax rate increased to 22.0% for the first nine months of 2012 from 18.6% from the same period in the prior year due to an increase in taxable income, primarily from gains realized from the sale of securities during the period. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 22.0% for the nine months ended September 30, 2012, was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## LIQUIDITY

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB and Federal Reserve and amortization and prepayments of outstanding loans and maturing securities. During the three and nine months ended September 30, 2012, the Corporation used its sources of funds primarily to fund loan originations and security purchases. As of September 30, 2012, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$54.9 million, and standby letters of credit totaling \$220,000.

At September 30, 2012, time deposits amounted to \$135.9 million or 30.0% of the Corporation's total consolidated deposits, including approximately \$59.0 million of which are scheduled to mature within the next year. Management of the Corporation believes it has adequate resources to fund all of its commitments, all of its commitments will be funded as required by related maturity dates and, based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve's discount

window. At September 30, 2012, the Corporation's borrowing capacity with the FHLB, net of funds borrowed, was \$155.9 million.

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

## 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, 2011. 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 future 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. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. 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, 2011, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date.

### **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, at September 30, 2012, the Corporation's interest-earning assets maturing or repricing within one year totaled \$146.1 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$172.9 million, providing an excess of interest-bearing liabilities over interest-earning assets of \$26.8 million. At September 30, 2012, the percentage of the Corporation's liabilities to assets maturing or repricing within one year was 118.3%.

For more information, see “Market Risk Management” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2011.

**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, 2012, 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**

There have been no material changes from those risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2011, as filed with the Securities and Exchange Commission. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations.

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

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

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

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

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

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

101.INS XBRL Instance Document\*

101.SCH XBRL Taxonomy Extension Schema Document\*

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document\*

101.DEF XBRL Taxonomy Extension Definitions Linkbase Document\*

101.LAB XBRL Taxonomy Extension Label Linkbase Document\*

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document\*

\* These interactive data files shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.



**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 AND SUBSIDIARIES

Date: November 13, 2012 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief Executive Officer

Date: November 13, 2012 By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer