

EMCLAIRE FINANCIAL CORP  
Form 10-K  
March 24, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One):

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

For the fiscal year ended: December 31, 2015

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: 000-18464

**EMCLAIRE FINANCIAL CORP**

(Exact name of registrant as specified in its charter)

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

612 Main Street, Emlenton, PA 16373  
(Address of principal executive office) (Zip Code)

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Registrant's telephone number: (844) 767-2311

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$1.25 per share NASDAQ Capital Markets (NASDAQ)  
(Title of Class) (Name of exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES  NO .

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES  NO .

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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 month (or for such shorter period that the registrant was required to submit and post such files). YES  NO .

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

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 Act). YES  NO .

As of June 30, 2015, the aggregate value of the 1,809,195 shares of Common Stock of the Registrant issued and outstanding on such date, which excludes 324,663 shares held by the directors and officers of the Registrant as a group, was approximately \$43.3 million. This figure is based on the last sales price of \$23.94 per share of the Registrant's Common Stock on June 30, 2015. The number of outstanding shares of common stock as of March 24, 2016, was 2,144,808.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2016 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

**EMCLAIRE FINANCIAL CORP**

**TABLE OF CONTENTS**

**PART I**

Item 1. <u>Business</u>	K-3
Item 1A. <u>Risk Factors</u>	K-21
Item 1B. <u>Unresolved Staff Comments</u>	K-21
Item 2. <u>Properties</u>	K-21
Item 3. <u>Legal Proceedings</u>	K-21
Item 4. <u>Mine Safety Disclosures</u>	K-21

**PART II**

Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	K-21
Item 6. <u>Selected Financial Data</u>	K-22
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	K-22
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	K-33
Item 8. <u>Financial Statements and Supplementary Data</u>	K-33
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	K-33
Item 9A. <u>Controls and Procedures</u>	K-34
Item 9B. <u>Other Information</u>	K-34

**PART III**

Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	K-34
Item 11. <u>Executive Compensation</u>	K-35

Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	K-35
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	K-35
Item 14. <u>Principal Accountant Fees and Services</u>	K-35

**PART IV**

Item 15. <u>Exhibits and Financial Statement Schedules</u>	K-36
--	------

**SIGNATURES AND CERTIFICATIONS**

K-38

K-2

*Discussions of certain matters in this Form 10-K and other related year end documents may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words or phrases such as “believe”, “plan”, “expect”, “intend”, “anticipate”, “estimate”, “project”, “forecast”, “may increase”, “may fluctuate”, “may improve” and similar expressions, or future or conditional verbs such as “will”, “should”, “would”, and “could”. These forward-looking statements relate to, among other things, expectations of the business environment in which the Corporation operates, projections of future performance, potential future credit experience, perceived opportunities in the market and statements regarding the Corporation’s mission and vision. The Corporation’s actual results, performance and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include, but are not limited to, changes in interest rates, general economic conditions, the local economy, the demand for the Corporation’s products and services, accounting principles or guidelines, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, U.S. Treasury, and Federal Reserve, real estate markets, competition in the financial services industry, attracting and retaining key personnel, performance of new employees, regulatory actions, changes in and utilization of new technologies and other risks detailed in the Corporation’s reports filed with the Securities and Exchange Commission (SEC) from time to time. These factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. The Corporation does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.*

## **PART I**

### **Item 1. Business**

#### **General**

Emclair Financial Corp (the Corporation) is a Pennsylvania corporation and financial holding company that provides a full range of retail and commercial financial products and services to customers in western Pennsylvania through its wholly owned subsidiary bank, The Farmers National Bank of Emlenton (the Bank). The Corporation also provides real estate settlement services through its subsidiary, Emclair Settlement Services, LLC (the Title Company).

The Bank was organized in 1900 as a national banking association and is a financial intermediary whose principal business consists of attracting deposits from the general public and investing such funds in real estate loans secured by liens on residential and commercial property, consumer loans, commercial business loans, marketable securities and interest-earning deposits. The Bank currently operates through a network of fifteen retail branch offices in Venango,

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Butler, Clarion, Clearfield, Crawford, Elk, Jefferson and Mercer counties, Pennsylvania. The Corporation and the Bank are headquartered in Emlenton, Pennsylvania.

The Bank is subject to examination and comprehensive regulation by the Office of the Comptroller of the Currency (OCC), which is the Bank's chartering authority, and the Federal Deposit Insurance Corporation (FDIC), which insures customer deposits held by the Bank to the full extent provided by law. The Bank is a member of the Federal Reserve Bank of Cleveland (FRB) and the Federal Home Loan Bank of Pittsburgh (FHLB). The Corporation is a registered bank holding company pursuant to the Bank Holding Company Act of 1956, as amended (BHCA), and a financial holding company under the Gramm-Leach Bliley Act of 1999 (GLBA).

At December 31, 2015, the Corporation had \$600.6 million in total assets, \$52.8 million in stockholders' equity, \$429.9 million in net loans and \$489.9 million in total deposits.

K-3

On December 30, 2015, the Corporation announced the signing of a definitive merger agreement under which United American Savings Bank (United American) will merge into The Farmers National Bank of Emlenton in a cash transaction valued at approximately \$14.1 million. United American is a traditional community bank with one branch location in Pittsburgh Pennsylvania, with reported assets of approximately \$89.3 million at December 31, 2015.

Under the terms of the agreement, shareholders of United American will receive \$42.67 in cash for each share of United American common stock. The transaction is expected to be completed in the second quarter of 2016, subject to the satisfaction of customary closing conditions, including regulatory approval and the approval of the shareholders of United American.

### **Lending Activities**

**General.** The principal lending activities of the Corporation are the origination of residential mortgage, commercial mortgage, commercial business and consumer loans. Nearly all of the Corporation's loans are originated in and secured by property within the Corporation's primary market area.

**One-to-Four Family Mortgage Loans.** The Corporation offers first mortgage loans secured by one-to-four family residences located mainly in the Corporation's primary lending area. One-to-four family mortgage loans amounted to 32.0% of the total loan portfolio at December 31, 2015. Typically such residences are single-family owner occupied units. The Corporation is an approved, qualified lender for the Federal Home Loan Mortgage Corporation (FHLMC) and the FHLB. As a result, the Corporation may sell loans to and service loans for the FHLMC and FHLB in market conditions and circumstances where this is advantageous in managing interest rate risk.

**Home Equity Loans.** The Corporation originates home equity loans secured by single-family residences. Home equity loans amounted to 20.1% of the total loan portfolio at December 31, 2015. These loans may be either a single advance fixed-rate loan with a term of up to 20 years or a variable rate revolving line of credit. These loans are made only on owner-occupied single-family residences.

**Commercial Business and Commercial Real Estate Loans.** Commercial lending constitutes a significant portion of the Corporation's lending activities. Commercial business and commercial real estate loans amounted to 46.3% of the total loan portfolio at December 31, 2015. Commercial real estate loans generally consist of loans granted for commercial purposes secured by commercial or other nonresidential real estate. Commercial loans consist of secured and unsecured loans for such items as capital assets, inventory, operations and other commercial purposes.



**Consumer Loans.** Consumer loans generally consist of fixed-rate term loans for automobile purchases, home improvements not secured by real estate, capital and other personal expenditures. The Corporation also offers unsecured revolving personal lines of credit and overdraft protection. Consumer loans amounted to 1.6% of the total loan portfolio at December 31, 2015.

**Loans to One Borrower.** National banks are subject to limits on the amount of credit that they can extend to one borrower. Under current law, loans to one borrower are limited to an amount equal to 15% of unimpaired capital and surplus on an unsecured basis, and an additional amount equal to 10% of unimpaired capital and surplus if the loan is secured by readily marketable collateral. At December 31, 2015, the Bank's loans to one borrower limit based upon 15% of unimpaired capital was \$8.4 million. The Bank may grant credit to borrowers in excess of the legal lending limit as part of the Legal Lending Limit Pilot Program approved by the OCC which allows the Bank to exceed its legal lending limit within certain parameters. At December 31, 2015, the Bank's largest single lending relationship had an outstanding balance of \$8.4 million.

**Loan Portfolio.** The following table sets forth the composition and percentage of the Corporation's loans receivable in dollar amounts and in percentages of the portfolio as of December 31:

<i>(Dollar amounts in thousands)</i>	2015		2014		2013		2012		2011	
	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%
<b>Mortgage loans on real estate:</b>										
Residential first mortgages	\$ 139,305	32.0 %	\$ 107,173	27.8 %	\$ 105,541	29.5 %	\$ 97,246	28.7 %	\$ 93,610	
Home equity loans and lines of credit	87,410	20.1 %	89,106	23.2 %	87,928	24.6 %	85,615	25.2 %	71,238	
Commercial	129,691	29.8 %	110,810	28.8 %	101,499	28.5 %	98,823	29.2 %	94,765	
<b>Total real estate loans</b>	<b>356,406</b>	<b>81.9 %</b>	<b>307,089</b>	<b>79.8 %</b>	<b>294,968</b>	<b>82.6 %</b>	<b>281,684</b>	<b>83.1 %</b>	<b>259,613</b>	
<b>Other loans:</b>										
Commercial business	71,948	16.5 %	70,185	18.2 %	53,214	14.9 %	45,581	13.4 %	43,826	
Consumer	6,742	1.6 %	7,598	2.0 %	9,117	2.6 %	11,886	3.5 %	12,642	
<b>Total other loans</b>	<b>78,690</b>	<b>18.1 %</b>	<b>77,783</b>	<b>20.2 %</b>	<b>62,331</b>	<b>17.4 %</b>	<b>57,467</b>	<b>16.9 %</b>	<b>56,468</b>	
<b>Total loans receivable</b>	<b>435,096</b>	<b>100.0%</b>	<b>384,872</b>	<b>100.0%</b>	<b>357,299</b>	<b>100.0%</b>	<b>339,151</b>	<b>100.0%</b>	<b>316,081</b>	
<b>Less:</b>										
Allowance for loan losses	5,205		5,224		4,869		5,350		3,536	
<b>Net loans receivable</b>	<b>\$429,891</b>		<b>\$379,648</b>		<b>\$352,430</b>		<b>\$333,801</b>		<b>\$312,545</b>	

The following table sets forth the final maturity of loans in the Corporation's portfolio as of December 31, 2015. Demand loans having no stated schedule of repayment and no stated maturity are reported as due within one year.

<i>(Dollar amounts in thousands)</i>	Due in one year or less	Due from one to five years	Due from five to ten years	Due after ten years	Total
Residential mortgages	\$ 4,544	\$ 1,805	\$ 6,967	\$ 125,989	\$ 139,305
Home equity loans and lines of credit	94	8,624	24,539	54,153	87,410
Commercial mortgages	6,487	5,724	49,925	67,555	129,691
Commercial business	4,124	19,111	15,080	33,633	71,948
Consumer	153	3,521	955	2,113	6,742
	\$ 15,402	\$ 38,785	\$ 97,466	\$ 283,443	\$ 435,096

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

The following table sets forth the dollar amount of the Corporation's fixed and adjustable rate loans with maturities greater than one year as of December 31, 2015:

<i>(Dollar amounts in thousands)</i>	Fixed rates	Adjustable rates
Residential mortgage	\$ 123,741	\$ 11,020
Home equity loans and lines of credit	73,751	13,564
Commercial mortgage	20,456	102,748
Commercial business	26,872	40,952
Consumer	4,873	1,717
	\$249,693	\$ 170,001

Contractual maturities of loans do not reflect the actual term of the Corporation's loan portfolio. The average life of mortgage loans is substantially less than their contractual terms because of loan prepayments and enforcement of due-on-sale clauses, which give the Corporation the right to declare a loan immediately payable in the event, among other things, that the borrower sells the real property subject to the mortgage. Scheduled principal amortization also reduces the average life of the loan portfolio. The average life of mortgage loans tends to increase when current market mortgage rates substantially exceed rates on existing mortgages and conversely, decrease when rates on existing mortgages substantially exceed current market interest rates.

## Delinquencies and Classified Assets

***Delinquent Loans and Other Real Estate Acquired Through Foreclosure (OREO).*** Typically, a loan is considered past due and a late charge is assessed when the borrower has not made a payment within fifteen days from the payment due date. When a borrower fails to make a required payment on a loan, the Corporation attempts to cure the deficiency by contacting the borrower. The initial contact with the borrower is made shortly after the seventeenth day following the due date for which a payment was not received. In most cases, delinquencies are cured promptly.

If the delinquency exceeds 60 days, the Corporation works with the borrower to set up a satisfactory repayment schedule. Typically, loans are considered nonaccruing upon reaching 90 days delinquent unless the credit is well secured and in the process of collection, although the Corporation may be receiving partial payments of interest and partial repayments of principal on such loans. When a loan is placed in nonaccrual status, previously accrued but unpaid interest is deducted from interest income. The Corporation institutes foreclosure action on secured loans only if all other remedies have been exhausted. If an action to foreclose is instituted and the loan is not reinstated or paid in full, the property is sold at a judicial or trustee's sale at which the Corporation may be the buyer.

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at fair value at the date of foreclosure less costs to sell, thereby establishing a new cost basis. After foreclosure, management periodically performs valuations and the real estate is carried at the lower of carrying amount or fair value less the cost to sell the property. Revenue and expenses from operations and changes in the valuation allowance are included in the loss on foreclosed real estate. The Corporation generally attempts to sell its OREO properties as soon as practical upon receipt of clear title.

As of December 31, 2015, the Corporation's nonperforming assets were \$3.2 million, or 0.54% of the Corporation's total assets, compared to \$7.1 million or 1.21% of the Corporation's total assets, at December 31, 2014. Nonperforming assets at December 31, 2015 included nonaccrual loans and OREO of \$3.1 million and \$160,000, respectively. Included in nonaccrual loans at December 31, 2015 were 5 loans totaling \$363,000 considered to be troubled debt restructurings (TDRs). Interest income of \$142,000 would have been recorded in 2015 if the nonaccrual loans had been current and performing during the entire period. Interest of \$53,000 on these loans was included in income during 2015.

***Classified Assets.*** Regulations applicable to insured institutions require the classification of problem assets as "substandard," "doubtful," or "loss" depending upon the existence of certain characteristics as discussed below. A category designated "special mention" must also be maintained for assets currently not requiring the above classifications but having potential weakness or risk characteristics that could result in future problems. An asset is classified as substandard if not adequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. A substandard asset is characterized by the distinct possibility that the Corporation will sustain some

loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified as substandard. In addition, these weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable or improbable. Assets classified as loss are considered uncollectible and of such little value that their continuance as assets is not warranted.

The Corporation's classification of assets policy requires the establishment of valuation allowances for loan losses in an amount deemed prudent by management. Valuation allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities. When the Corporation classifies a problem asset as a loss, the portion of the asset deemed uncollectible is charged off immediately.

The Corporation regularly reviews the problem loans and other assets in its portfolio to determine whether any require classification in accordance with the Corporation's policy and applicable regulations. As of December 31, 2015, the Corporation's classified and criticized assets amounted to \$8.0 million or 1.3% of total assets, with \$1.0 million identified as special mention and \$6.9 million classified as substandard.

Included in classified and criticized assets at December 31, 2015 are two large loan relationships exhibiting credit deterioration impacting the ability of the borrowers to comply with their present loan repayment terms on a timely basis.

The first loan, with an outstanding balance of \$2.7 million at December 31, 2015, was originated for the construction of a hotel, restaurant and retail plaza secured by such property and the borrower's personal residence. The hotel, restaurant and retail plaza are complete and operational. However, cash flows from operations have not been consistent and are impacted by the seasonal nature of the hotel. In addition, the borrower has limited liquid sources of repayment. As a result, the borrower has listed substantial real estate holdings for sale. At December 31, 2015, the loan was performing and classified as substandard. Ultimately, due to the estimated value of the borrower's significant real estate holdings, the Corporation does not currently expect to incur a loss on this loan.

The second relationship, with an outstanding balance of \$1.0 million at December 31, 2015, is considered impaired and consists of one commercial real estate mortgage loan and two commercial business loans. The loans are secured by lien positions on the manufacturing facilities, equipment and other business assets. The borrower has experienced a substantial decrease in sales revenue due to a decrease in market demand for their primary product and pricing pressures in general. Sales efforts have been overhauled and new products segments have been launched. While revenues have stabilized, cash flow remains negative. All loans have remained current, due in part to financial support of the business owner. At December 31, 2015, the loans were nonperforming, classified as substandard and had a specific reserve of \$47,000 allocated to them.

The following table sets forth information regarding the Corporation's nonperforming assets as of December 31:

(Dollar amounts in thousands)	2015	2014	2013	2012	2011
Nonperforming loans	\$3,069	\$6,942	\$5,207	\$6,988	\$5,565
Total as a percentage of gross loans	0.71 %	1.80 %	1.46 %	2.06 %	1.76 %
Repossessions	-	-	-	-	-
Real estate acquired through foreclosure	160	124	107	180	307
Total as a percentage of total assets	0.03 %	0.02 %	0.02 %	0.04 %	0.06 %
Total nonperforming assets	\$3,229	\$7,066	\$5,314	\$7,168	\$5,872
Total nonperforming assets as a percentage of total assets	0.54 %	1.21 %	1.01 %	1.41 %	1.19 %
Allowance for loan losses as a percentage of nonperforming loans	169.60 %	75.25 %	93.51 %	76.56 %	63.54 %

***Allowance for Loan Losses.*** Management establishes allowances for estimated losses on loans based upon its evaluation of the pertinent factors underlying the types and quality of loans; historical loss experience based on volume and types of loans; trend in portfolio volume and composition; level and trend on nonperforming assets; detailed analysis of individual loans for which full collectability may not be assured; determination of the existence and realizable value of the collateral and guarantees securing such loans and the current economic conditions affecting the collectability of loans in the portfolio. The Corporation analyzes its loan portfolio at least quarterly for valuation purposes and to determine the adequacy of its allowance for losses. Based upon the factors discussed above, management believes that the Corporation's allowance for losses as of December 31, 2015 of \$5.2 million was adequate to cover probable incurred losses in the portfolio at such time.

K-7





Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Commercial, financial and agricultural	\$960	16.5%	\$1,336	18.2%	\$822	14.9%	\$636	13.4%	\$590	13.9%
Commercial mortgages	2,185	29.8%	2,338	28.8%	2,450	28.4%	3,090	29.2%	1,737	30.0%
Residential mortgages	1,429	32.0%	955	27.8%	923	29.5%	828	28.7%	832	29.6%
Home equity loans	586	20.1%	543	23.2%	625	24.6%	730	25.2%	320	22.5%
Consumer loans	45	1.6%	52	2.0%	49	2.6%	66	3.5%	57	4.0%
	\$5,205	100%	\$5,224	100%	\$4,869	100%	\$5,350	100%	\$3,536	100%

**Investment Activities**

**General.** The Corporation maintains an investment portfolio of securities such as U.S. government agencies, mortgage-backed securities, municipal and equity securities.

Investment decisions are made within policy guidelines as established by the Board of Directors. This policy is aimed at maintaining a diversified investment portfolio, which complements the overall asset/liability and liquidity objectives of the Corporation, while limiting the related credit risk to an acceptable level.

The following table sets forth certain information regarding the fair value, weighted average yields and contractual maturities of the Corporation's securities as of December 31, 2015:

<i>(Dollar amounts in thousands)</i>	Due in 1 year or less	Due from 1 to 3 years	Due from 3 to 5 years	Due from 5 to 10 years	Due after 10 years	No scheduled maturity	Total
U.S. Treasury and federal agency	\$ -	\$ -	\$ 1,466	\$ -	\$ -	\$ -	\$ 1,466
U.S. government sponsored entities and agencies	-	1,989	6,964	-	-	-	8,953
U.S. agency mortgage-backed securities: residential	-	-	-	-	33,150	-	33,150
U.S. agency collateralized mortgage obligations: residential	-	-	-	-	31,440	-	31,440
Corporate securities	499	3,495	-	3,493	-	-	7,487
State and political subdivision	723	1,552	5,457	20,609	250	-	28,591
Equity securities	-	-	-	-	-	1,894	1,894
Estimated fair value	\$ 1,222	\$ 7,036	\$ 13,887	\$ 24,102	\$ 64,840	\$ 1,894	\$ 112,981
Weighted average yield (1)	3.41 %	1.85 %	2.09 %	3.64 %	2.58 %	3.05 %	2.72 %

(1) Taxable equivalent adjustments have been made in calculating yields on state and political subdivision securities.

The following table sets forth the fair value of the Corporation's investment securities as of December 31:

<i>(Dollar amounts in thousands)</i>	2015	2014	2013
U.S. Treasury and federal agency	\$ 1,466	\$ 1,456	\$ 4,168
U.S. government sponsored entities and agencies	8,953	35,224	22,892
U.S. agency mortgage-backed securities: residential	33,150	38,771	11,361
U.S. agency collateralized mortgage obligations: residential	31,440	36,617	39,722
Corporate securities	7,487	1,998	241
State and political subdivision	28,591	33,024	36,499
Equity securities	1,894	2,771	2,421
	\$ 112,981	\$ 149,861	\$ 117,304

For additional information regarding the Corporation's investment portfolio see "Note 4 – Securities" on page F-16 to the consolidated financial statements.

## Sources of Funds

**General.** Deposits are the primary source of the Corporation's funds for lending and investing activities. Secondary sources of funds are derived from loan repayments, investment maturities and borrowed funds. Loan repayments can be considered a relatively stable funding source, while deposit activity is greatly influenced by interest rates and general market conditions. The Corporation also has access to funds through other various sources. For additional information about the Corporation's sources of funds, see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity" in item 7.

**Deposits.** The Corporation offers a wide variety of deposit account products to both consumer and commercial deposit customers, including time deposits, noninterest bearing and interest bearing demand deposit accounts, savings deposits and money market accounts.

Deposit products are promoted in periodic newspaper, radio and other forms of advertisements, along with notices provided in customer account statements. The Corporation's marketing strategy is based on its reputation as a community bank that provides quality products and personalized customer service.

The Corporation sets interest rates on its interest bearing deposit products that are competitive with rates offered by other financial institutions in its market area. Management reviews interest rates on deposits bi-weekly and considers a number of factors, including: (1) the Corporation's internal cost of funds; (2) rates offered by competing financial institutions; (3) investing and lending opportunities; and (4) the Corporation's liquidity position.

The following table summarizes the Corporation's deposits as of December 31:

(Dollar amounts in thousands)	2015			2014		
Type of accounts	Weighted average rate	Amount	%	Weighted average rate	Amount	%
Non-interest bearing deposits	-	\$119,790	24.4 %	-	\$111,282	22.2 %
Interest bearing demand deposits	0.15 %	256,620	52.4 %	0.15 %	269,402	53.7 %
Time deposits	1.46 %	113,477	23.2 %	1.52 %	121,135	24.1 %
	0.42 %	\$489,887	100.0 %	0.45 %	\$501,819	100.0 %

The following table sets forth maturities of the Corporation's time deposits of \$250,000 or more at December 31, 2015 by time remaining to maturity:

(Dollar amounts in thousands)	Amount
Three months or less	\$2,773
Over three months to six months	1,101
Over six months to twelve months	6,366
Over twelve months	11,999
	\$22,239

**Borrowings.** Borrowings may be used to compensate for reductions in deposit inflows or net deposit outflows, or to support lending and investment activities. These borrowings include FHLB advances, federal funds, repurchase agreements, advances from the Federal Reserve Discount Window and lines of credit at the Bank and the Corporation with other correspondent banks. The following table summarizes information with respect to borrowings at or for the years ending December 31:

(Dollar amounts in thousands)	2015	2014
Ending balance	\$49,250	\$21,500
Average balance	21,489	19,417
Maximum balance	55,750	39,650
Average rate	3.21 %	3.49 %

For additional information regarding the Corporation's deposit base and borrowed funds, see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Deposits and Borrowed Funds" in item 7 and "Note 10 – Deposits" on page F-28 and "Note 11 – Borrowed Funds" on page F-29 to the consolidated financial statements.

### **Subsidiary Activity**

The Corporation has two wholly owned subsidiaries, the Bank and the Title Company. The Title Company provides real estate settlement services to the Bank and other customers. As of December 31, 2015, the Bank and the Title Company had no subsidiaries.

### **Personnel**

At December 31, 2015, the Corporation had 122 full time equivalent employees. There is no collective bargaining agreement between the Corporation and its employees, and the Corporation believes its relationship with its employees is satisfactory.

K-10

## Competition

The Corporation competes for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions and other nonbank financial service providers.

## Supervision and Regulation

**General.** Bank holding companies and banks are extensively regulated under both federal and state law. Set forth below is a summary description of certain provisions of certain laws that relate to the regulation of the Corporation and the Bank. The description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

**The Corporation.** The Corporation is a registered bank holding company and subject to regulation and examination by the FRB under the BHCA. The Corporation is required to file periodic reports with the FRB and such additional information as the FRB may require. Recent changes to the Bank Holding Company rating system emphasize risk management and evaluation of the potential impact of non-depository entities on safety and soundness.

The FRB may require the Corporation to terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances, the Corporation must file written notice and obtain FRB approval prior to purchasing or redeeming its equity securities.

The Corporation is required to obtain prior FRB approval for the acquisition of more than 5% of the outstanding shares of any class of voting securities or substantially all of the assets of any bank or bank holding company. Prior FRB approval is also required for the merger or consolidation of the Corporation and another bank holding company.

The BHCA generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to its subsidiaries. However, subject to the prior FRB approval, a bank holding company may engage in any,

or acquire shares of companies engaged in, activities that the FRB deems to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The BHCA also authorizes bank holding companies to engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake these activities, a bank holding company must become a financial holding company by submitting to the appropriate FRB a declaration that the company elects to be a financial holding company and a certification that all of the depository institutions controlled by the company are well capitalized and well managed. The Corporation submitted the declaration of election to become a financial holding company with the FRB of Cleveland in February 2007, and the election became effective in March 2007. Recent federal legislation also directed federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries.

K-11

Under FRB regulations, the Corporation is required to serve as a source of financial and managerial strength to the Bank and may not conduct operations in an unsafe or unsound manner. In addition, it is the FRB's policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of FRB regulations or both.

The Corporation is also a bank holding company within the meaning of the Pennsylvania Banking Code. As such, the Corporation and its subsidiaries are subject to examination by, and may be required to file reports with, the Pennsylvania Department of Banking and Securities.

The Corporation's securities are registered with the SEC under the Exchange Act. As such, the Corporation is subject to the information, proxy solicitation, insider trading, corporate governance, and other requirements and restrictions of the Exchange Act. The public may obtain all forms and information filed with the SEC through its website <http://www.sec.gov>.

In December 2013, federal regulators adopted final rules to implement the provisions of the Dodd Frank Act commonly referred to as the Volcker Rule and established July 21, 2015 as the end of the conformance period. The regulations contain prohibitions and restrictions on the ability of financial institutions, holding companies and their affiliates to engage in proprietary trading and to hold certain interests in, or to have certain relationships with, various types of investment funds, including hedge funds and private equity funds.

**The Bank.** As a national banking association, the Bank is subject to primary supervision, examination and regulation by the OCC. The Bank is also subject to regulations of the FDIC as administrator of the Deposit Insurance Fund (DIF) and the FRB. If, as a result of an examination of the Bank, the OCC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of the Bank's operations are unsatisfactory or that the Bank is violating or has violated any law or regulation, various remedies are available to the OCC. Such remedies include the power to enjoin "unsafe or unsound practices," to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the Bank's growth, to assess civil monetary penalties, and to remove officers and directors. The FDIC has similar enforcement authority, in addition to its authority to terminate the Bank's deposit insurance in the absence of action by the OCC and upon a finding that the Bank is operating in an unsafe or unsound condition, is engaging in unsafe or unsound activities, or that the Bank's conduct poses a risk to the deposit insurance fund or may prejudice the interest of its depositors.



A national bank may have a financial subsidiary engaged in any activity authorized for national banks directly or certain permissible activities. Generally, a financial subsidiary is permitted to engage in activities that are “financial in nature” or incidental thereto, even though they are not permissible for the national bank itself. The definition of “financial in nature” includes, among other items, underwriting, dealing in or making a market in securities, including, for example, distributing shares of mutual funds. The subsidiary may not, however, engage as principal in underwriting insurance, issue annuities or engage in real estate development or investment or merchant banking.

K-12

***The Sarbanes-Oxley Act of 2002.*** The Sarbanes-Oxley Act of 2002 established a comprehensive framework to modernize and reform the oversight of public company auditing, improve the quality and transparency of financial reporting by those companies and strengthen the independence of auditors. Among other things, the legislation (i) created a public company accounting oversight board that is empowered to set auditing, quality control and ethics standards, to inspect registered public accounting firms, to conduct investigations and to take disciplinary actions, subject to SEC oversight and review; (ii) strengthened auditor independence from corporate management by limiting the scope of consulting services that auditors can offer their public company audit clients; (iii) heightened the responsibility of public company directors and senior managers for the quality of the financial reporting and disclosure made by their companies; (iv) adopted a number of provisions to deter wrongdoing by corporate management; (v) imposed a number of new corporate disclosure requirements; (vi) adopted provisions which generally seek to limit and expose to public view possible conflicts of interest affecting securities analysis; and (vii) imposed a range of new criminal penalties for fraud and other wrongful acts and extended the period during which certain types of lawsuits can be brought against a company or its insiders.

***2010 Regulatory Reform.*** On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was signed into law. The goals of the Dodd-Frank Act included restoring public confidence in the financial system following the financial crisis, preventing another financial crisis and permitting regulators to identify shortfalls in the system before another financial crisis can occur. The Dodd Frank Act is also intended to promote a fundamental restructuring of federal banking regulation by taking a systemic view of regulation rather than focusing on regulation of individual financial institutions.

Many of the provisions in the Dodd Frank Act require that regulatory agencies draft implementing regulations. Implementation of the Dodd Frank Act has had and will continue to have a broad impact on the financial services industry by introducing significant regulatory and compliance changes including, among other things: (i) changing the assessment base for federal deposit insurance from the amount of insured deposits to average consolidated total assets less average tangible equity, eliminating the ceiling and increasing the size of the floor of the DIF and offsetting the impact of the increase in the minimum floor on institutions with less than \$10 billion in assets; (ii) making permanent the \$250,000 limit for federal deposit insurance and increasing the cash limit of Securities Investor Protection Corporation protection to \$250,000; (iii) eliminating the requirement that the FDIC pay dividends from the DIF when the reserve ratio is between 1.35% and 1.50%, but continuing the FDIC's authority to declare dividends when the reserve ratio at the end of a calendar year is at least 1.50%; however, the FDIC is granted sole discretion in determining whether to suspend or limit the declaration or payment of dividends; (iv) repealing the federal prohibition on payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts; (v) implementing certain corporate governance revisions that apply to all public companies, including regulations that require publicly traded companies to give shareholders a non-binding advisory vote to approve executive compensation, commonly referred to as a "say-on-pay" vote and an advisory role on so-called "golden parachute" payments in connection with approvals of mergers and acquisitions; new director independence requirements and considerations to be taken into account by compensation committees and their advisers relating to executive compensation; additional executive compensation disclosures; and a requirement that companies adopt a policy providing for the recovery of executive compensation in the event of a restatement of its financial statements, commonly referred to as a "clawback" policy; (vi) centralizing responsibility for consumer financial protection by creating a new independent federal agency, the Consumer Financial Protection Bureau (CFPB) responsible for implementing federal consumer protection laws to be applicable to all depository institutions; (vii) imposing new

requirements for mortgage lending, including new minimum underwriting standards, limitations on prepayment penalties and imposition of new mandated disclosures to mortgage borrowers; (viii) imposing new limits on affiliate transactions and causing derivative transactions to be subject to lending limits and other restrictions including adoption of the “Volcker Rule” regulating transactions in derivative securities; (ix) limiting debit card interchange fees that financial institutions with \$10 billion or more in assets are permitted to charge their customers; and (x) implementing regulations to incentivize and protect individuals, commonly referred to as whistleblowers to report violations of federal securities laws.

K-13

Many aspects of the Dodd Frank Act continue to be subject to rulemaking and will take effect over several additional years, making it difficult to anticipate the overall financial impact on us or across the industry. The changes resulting from the Dodd Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business.

**Anti-Money Laundering.** All financial institutions, including national banks, are subject to federal laws that are designed to prevent the use of the U.S. financial system to fund terrorist activities. Financial institutions operating in the United States must develop anti-money laundering compliance programs, due diligence policies and controls to ensure the detection and reporting of money laundering. Such compliance programs are intended to supplement compliance requirements, also applicable to financial institutions, under the Bank Secrecy Act and the Office of Foreign Assets Control Regulations. The Bank has established policies and procedures to ensure compliance with these provisions.

**Privacy.** Federal banking rules limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to these rules, financial institutions must provide (i) initial notices to customers about their privacy policies, describing conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates; (ii) annual notices of their privacy policies to current customers and (iii) a reasonable method for customers to “opt out” of disclosures to nonaffiliated third parties. These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. The Corporation’s privacy policies have been implemented in accordance with the law.

**Dividends and Other Transfers of Funds.** Dividends from the Bank constitute the principal source of income to the Corporation. The Corporation is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Corporation. In addition, the Bank’s regulators have the authority to prohibit the Bank from paying dividends, depending upon the Bank’s financial condition, if such payment is deemed to constitute an unsafe or unsound practice.

**Limitations on Transactions with Affiliates.** Transactions between national banks and any affiliate are governed by Sections 23A and 23B of the Federal Reserve Act. An affiliate of a national bank includes any company or entity which controls the national bank or that is controlled by a company that controls the national bank. In a holding company context, the holding company of a national bank (such as the Corporation) and any companies which are controlled by such holding company are affiliates of the national bank. Generally, Section 23A limits the extent to which the national bank or its subsidiaries may engage in “covered transactions” with any one affiliate to an amount equal to 10% of such bank’s capital stock and surplus, and contains an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus. Section 23B applies to “covered transactions” as well as certain other transactions and requires that all transactions be on terms substantially the same, or at least favorable, to the national bank as those provided to a non-affiliate. The term “covered transaction” includes the making of loans to, purchase of assets from and issuance of a guarantee to an affiliate and similar transactions. Section 23B

transactions also include the provision of services and the sale of assets by a national bank to an affiliate.

K-14

In addition, Sections 22(g) and (h) of the Federal Reserve Act place restrictions on loans to executive officers, directors and principal shareholders of the national bank and its affiliates. Under Section 22(h), loans to a director, an executive officer and to a greater than 10% shareholder of a national bank, and certain affiliated interests of either, may not exceed, together with all other outstanding loans to such person and affiliated interests, the national bank's loans to one borrower limit (generally equal to 15% of the bank's unimpaired capital and surplus). Section 22(h) also requires that loans to directors, executive officers and principal shareholders be made on terms substantially the same as offered in comparable transactions to other persons unless the loans are made pursuant to a benefit or compensation program that (i) is widely available to employees of the bank and (ii) does not give preference to any director, executive officer or principal shareholder, or certain affiliated interests of either, over other employees of the national bank. Section 22(h) also requires prior board approval for certain loans. In addition, the aggregate amount of extensions of credit by a national bank to all insiders cannot exceed the bank's unimpaired capital and surplus. Furthermore, Section 22(g) places additional restrictions on loans to executive officers. The Bank currently is subject to Sections 22(g) and (h) of the Federal Reserve Act and at December 31, 2015, was in compliance with the above restrictions.

***Loans to One Borrower Limitations.*** With certain limited exceptions, the maximum amount that a national bank may lend to any borrower (including certain related entities of the borrower) at one time may not exceed 15% of the unimpaired capital and surplus of the institution, plus an additional 10% of unimpaired capital and surplus for loans fully secured by readily marketable collateral. At December 31, 2015, the Bank's loans-to-one-borrower limit was \$8.4 million based upon the 15% of unimpaired capital and surplus measurement. The Bank may grant credit to borrowers in excess of the legal lending limit as part of the Legal Lending Limit Pilot Program approved by the OCC which allows the Bank to exceed its legal lending limit within certain parameters. At December 31, 2015, the Bank's largest single lending relationship had an outstanding balance of \$8.4 million.

***Capital Standards.*** The Bank is required to comply with applicable capital adequacy standards established by the federal banking agencies. Beginning on January 1, 2015, the Bank became subject to a new comprehensive capital framework for U.S. banking organizations. In July 2013, the Federal Reserve Board, FDIC and OCC adopted a final rule that implements the Basel III changes to the international regulatory capital framework. The Basel III rules include requirements contemplated by the Dodd Frank Act as well as certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010.

The Basel III rules include new risk-based and leverage capital ratio requirements that refine the definition of what constitutes "capital" for purposes of calculating those ratios. The minimum capital level requirements are (i) a new common equity Tier 1 risk-based capital ratio of 4.5%; (ii) a Tier 1 risk-based capital ratio of 6% (increased from 4%); (iii) a total risk-based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. Common equity Tier 1 capital will consist of retained earnings and common stock instruments, subject to certain adjustments.

The Basel III rules also establish a fully-phased “capital conservation buffer” of 2.5% above the new regulatory minimum risk-based capital requirements. The conversation buffer, when added to the capital requirements, results in the following minimum ratios: (i) a common equity Tier 1 risk-based capital ratio of 7.0%, (ii) a Tier 1 risk-based capital ratio of 8.5% and (iii) a total risk-based capital ratio of 10.5%. The new capital conservation buffer requirement is to be phased in beginning January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019. An institution is subject to limitations on certain activities including payment of dividends, share repurchases and discretionary bonuses to executive officers if its capital level is below the buffer amount.

K-15

The Basel III rules also revise the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels do not meet certain thresholds. These revisions were effective January 1, 2015. The prompt corrective action rules were modified to include a common equity Tier 1 capital component and to increase certain other capital requirements for the various thresholds. Under the proposed prompt corrective action rules, insured depository institutions are required to meet the following capital levels in order to qualify as “well capitalized”: (i) a new common equity Tier 1 risk-based capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a total risk-based capital ratio of 10% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from previous rules).

The Basel III rules set forth certain changes in the methods of calculating risk-weighted assets, which in turn affect the calculation of risk based ratios. Under the Basel III rules, higher or more sensitive risk weights are assigned to various categories of assets including certain credit facilities that finance the acquisition, development or construction of real property, certain exposures of credits that are 90 days past due or on nonaccrual, foreign exposures and certain corporate exposures. In addition, Basel III rules include (i) alternate standards of credit worthiness consistent with the Dodd Frank Act; (ii) greater recognition of collateral guarantees and (iii) revised capital treatment for derivatives and repo-style transactions.

In addition, the final rule includes certain exemptions to address concerns about the regulatory burden on community banks. Banking organizations with less than \$15 billion in consolidated assets as of December 31, 2009 are permitted to include in Tier 1 capital trust preferred securities and cumulative perpetual preferred stock issued and included in Tier 1 capital prior to May 19, 2010 on a permanent basis without any phase out. Community banks were required to make this election by their March 31, 2015 quarterly filings with the appropriate federal regulator to opt-out of the requirement to include most accumulated other comprehensive income (AOCI) components in the calculation of Common equity Tier 1 capital and in effect retain the AOCI treatment under the current capital rules. The Bank made in its March 31, 2015 quarterly filing a one-time permanent election to continue to exclude accumulated other comprehensive income from capital. If it would not have made this election, unrealized gains and losses would have been included in the calculation of its regulatory capital.

The Basel III rules generally became effective beginning January 1, 2015; however, certain calculations under the Basel III rules have phase-in periods. In 2015, the Board of Governors of the Federal Reserve System amended its Small Bank Holding Company Policy Statement by increasing the policy’s consolidated assets threshold from \$500 million to \$1 billion. The primary benefit of being deemed a “small bank holding company” is the exemption from the requirement to maintain consolidated regulatory capital ratios; instead, regulatory capital ratios only apply at the subsidiary bank level.



The following table sets forth certain information concerning regulatory capital ratios of the Bank as of the dates presented:

<i>(Dollar amounts in thousands)</i>	December 31, 2015		December 31, 2014	
	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets:				
Actual	\$ 56,090	13.99 %	\$ 52,329	14.84 %
For capital adequacy purposes	32,070	8.00 %	28,201	8.00 %
To be well capitalized	40,087	10.00 %	35,251	10.00 %
Tier 1 capital to risk-weighted assets:				
Actual	\$ 51,073	12.74 %	\$ 47,878	13.58 %
For capital adequacy purposes	24,052	6.00 %	14,101	4.00 %
To be well capitalized	32,070	8.00 %	21,151	6.00 %
Common Equity Tier 1 capital to risk-weighted assets:				
Actual	\$ 51,073	12.74 %	N/A	N/A
For capital adequacy purposes	18,039	4.50 %	N/A	N/A
To be well capitalized	26,057	6.50 %	N/A	N/A
Tier 1 capital to average assets:				
Actual	\$ 51,073	8.83 %	\$ 47,878	8.25 %
For capital adequacy purposes	23,131	4.00 %	23,222	4.00 %
To be well capitalized	28,914	5.00 %	29,028	5.00 %

**Prompt Corrective Action and Other Enforcement Mechanisms.** Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including but not limited to those institutions that fall below one or more prescribed minimum capital ratios. Each federal banking agency has promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on its capital ratios: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. At December 31, 2015, the Bank exceeded the required ratios for classification as “well capitalized.”

An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions. The federal banking agencies, however, may not treat a significantly undercapitalized institution as critically undercapitalized.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting

their businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Finally, pursuant to an interagency agreement, the FDIC can examine any institution that has a substandard regulatory examination score or is considered undercapitalized – without the permission of the institution’s primary regulator.

K-17

***Safety and Soundness Standards.*** The federal banking agencies have adopted guidelines designed to assist the federal banking agencies in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems, (ii) loan documentation, (iii) credit underwriting, (iv) asset growth, (v) earnings, and (vi) compensation, fees and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, an insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets, (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses, (iii) compare problem asset totals to capital, (iv) take appropriate corrective action to resolve problem assets, (v) consider the size and potential risks of material asset concentrations, and (vi) provide periodic asset quality reports with adequate information for management and the board of directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

***Insurance of Accounts.*** Deposit insurance assessment payments, which are determined through a risk-based assessment system, are made to the DIF. Deposit accounts are currently insured by the DIF generally up to a maximum of \$250,000 per separately insured depositor.

Under the current assessment system, the FDIC assigns an institution to one of four risk categories designed to measure risk. Total base assessment rates currently range from 0.025% of deposits for an institution in the highest rated category to 0.45% of deposits for an institution in the lowest rated category. In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately six tenths of a basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2017 through 2019.

Under the Federal Deposit Insurance Act, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule order or condition imposed by the FDIC.

***Interstate Banking and Branching.*** Banks have the ability, subject to certain state restrictions, to acquire, by acquisition or merger, branches outside its home state. In addition, recent federal legislation permits a bank headquartered in Pennsylvania to enter another state through de novo branching (as compared to an acquisition) if under the state law in the state which the proposed branch is to be located a state-chartered institution would be permitted to establish the branch. Interstate branches are subject to certain laws of the states in which they are located. Competition may increase further as banks branch across state lines and enter new markets.

***Consumer Protection Laws and Regulations.*** The bank regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to carefully monitor compliance with such laws and regulations. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

K-18

The Community Reinvestment Act (CRA) is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank's record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, in a manner consistent with safe and sound banking practices. On September 1, 2005, the federal banking agencies amended the CRA regulations to (i) establish the definition of "Intermediate Small Bank" as an institution with total assets of \$250 million to \$1 billion, without regard to any holding company; and (ii) take into account abusive lending practices by a bank or its affiliates in determining a bank's CRA rating. The CRA further requires the agencies to take a financial institution's record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of "outstanding" to a low of "substantial noncompliance." In its last examination for CRA compliance, as of September 10, 2015, the Bank was rated "satisfactory."

The Fair Credit Reporting Act (FCRA), as amended by the Fair and Accurate Credit Transactions Act of 2003 (FACTA), requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and give consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with the FACTA, financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer's election to opt out would be applicable for at least five years.

The Federal Trade Commission (FTC), the federal bank regulatory agencies and the National Credit Union Administration (NCUA) have issued regulations (the Red Flag Rules) requiring financial institutions and creditors to develop and implement written identity theft prevention programs as part of the FACTA. The programs were required to be in place by May 1, 2009 and must provide for the identification, detection and response to patterns, practices or specific activities – known as red flags – that could indicate identity theft. These red flags may include unusual account activity, fraud alerts on a consumer report or attempted use of suspicious account application documents. The program must also describe appropriate responses that would prevent and mitigate the crime and detail a plan to update the program. The program must be managed by the Board of Directors or senior employees of the institution or creditor, include appropriate staff training and provide oversight of any service providers.

The Check Clearing for the 21<sup>st</sup> Century Act (Check 21) facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check," which is the legal equivalent of an original check. Check 21, effective October 28, 2004, does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original.

The Equal Credit Opportunity Act (ECOA) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in

limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act (TILA) is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

K-19

The Fair Housing Act (FHA) regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FHA, including some that are not specifically mentioned in the FHA itself.

The Home Mortgage Disclosure Act (HMDA) grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a “fair lending” aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The term “predatory lending,” much like the terms “safety and soundness” and “unfair and deceptive practices,” is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. Generally speaking, predatory lending involves at least one, and perhaps all three, of the following elements (i) making unaffordable loans based on the assets of the borrower rather than on the borrower’s ability to repay an obligation (“asset-based lending”); (ii) inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (“loan flipping”); and (iii) engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

FRB regulations aimed at curbing such lending significantly widened the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

Effective April 8, 2005, OCC guidelines require national banks and their operating subsidiaries to comply with certain standards when making or purchasing loans to avoid predatory or abusive residential mortgage lending practices. Failure to comply with the guidelines could be deemed an unsafe and unsound or unfair or deceptive practice, subjecting the bank to supervisory enforcement actions.

Finally, the Real Estate Settlement Procedures Act (RESPA) requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts. Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the CRA, FACTA, TILA, FHA, ECOA, HMDA and RESPA generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

***Federal Home Loan Bank System.*** The Bank is a member of the FHLB. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. At December 31, 2015, the Bank was in compliance with the stock requirements.

***Federal Reserve System.*** The FRB requires all depository institutions to maintain noninterest bearing reserves at specified levels against their transaction accounts (primarily checking) and non-personal time deposits. At December 31, 2015, the Bank was in compliance with these requirements.

K-20



**Item 1A. Risk Factors**

Not required as the Corporation is a smaller reporting company.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

The Corporation owns no real property but utilizes the main office of the Bank, which is owned by the Bank. The Corporation's and the Bank's executive offices are located at 612 Main Street, Emlenton, Pennsylvania. The Corporation pays no rent or other form of consideration for the use of this facility.

The Bank owns and leases numerous other premises for use in conducting business activities. The Bank considers these facilities owned or occupied under lease to be adequate. For additional information regarding the Bank's properties, see "Note 7 - Premises and Equipment" on page F-26 to the consolidated financial statements.

**Item 3. Legal Proceedings**

Neither the Bank nor the Corporation is involved in any material legal proceedings. The Bank, from time to time, is party to litigation that arises in the ordinary course of business, such as claims to enforce liens, claims involving the origination and servicing of loans, and other issues related to the business of the Bank. In the opinion of management, the resolution of any such issues would not have a material adverse impact on the financial position, results of operation, or liquidity of the Bank or the Corporation.

**Item 4. Mine Safety Disclosures**

Not applicable.

## **PART II**

### **Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

#### **Market, Holder and Dividend Information**

Emclair Financial Corp common stock is traded on NASDAQ Capital Market (NASDAQ) under the symbol "EMCF". The listed market makers for the Corporation's common stock include:

<b>Boenning and Scattergood, Inc.</b>	<b>Janney Montgomery Scott LLC</b>	<b>Monroe Securities, Inc.</b>
4 Tower Bridge	1717 Arch Street	100 North Riverside Plaza
200 Barr Harbor Drive, Suite 300	Philadelphia, PA 19103	Suite 1620
West Conshohocken, PA 19428-2979	Telephone: (215) 665-6000	Chicago, IL 60606
Telephone: (800) 883-1212		Telephone: (312) 327-2530

The Corporation has traditionally paid regular quarterly cash dividends. Future dividends will be determined by the Board of Directors after giving consideration to the Corporation's financial condition, results of operations, tax status, industry standards, economic conditions, regulatory requirements and other factors.

K-21

The following table sets forth the high and low sale and quarter-end closing market prices of our common stock for the last two years as reported by the Nasdaq Capital Market as well as cash dividends paid for the quarterly periods presented.

	Market Price		Close	Cash Dividend
	High	Low		
2015:				
Fourth quarter	\$25.00	\$22.90	\$24.00	\$ 0.24
Third quarter	24.96	22.85	22.90	0.24
Second quarter	25.96	22.52	23.94	0.24
First quarter	27.15	23.50	25.10	0.24
2014:				
Fourth quarter	\$26.95	\$23.48	\$25.00	\$ 0.22
Third quarter	27.50	24.82	25.46	0.22
Second quarter	27.04	24.20	26.89	0.22
First quarter	26.09	24.26	25.62	0.22

As of March 1, 2016, there were approximately 649 stockholders of record and 2,144,808 shares of common stock entitled to vote, receive dividends and considered outstanding for financial reporting purposes. The number of stockholders of record does not include the number of persons or entities who hold their stock in nominee or “street” name.

Common stockholders may have dividends reinvested to purchase additional shares through the Corporation’s dividend reinvestment plan. Participants may also make optional cash purchases of common stock through this plan. To obtain a plan document and authorization card to participate in the plan, please call 888-509-4619.

### **Purchases of Equity Securities**

The Corporation did not repurchase any of its equity securities in the year ended December 31, 2015.

### **Item 6. Selected Financial Data**

Not required as the Corporation is a smaller reporting company.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis represents a review of the Corporation's consolidated financial condition and results of operations for the years ended December 31, 2015 and 2014. This review should be read in conjunction with the consolidated financial statements beginning on page F-3.

### **Overview**

The Corporation reported consolidated net income available to common stockholders of \$4.1 million or \$2.05 per diluted common share for 2015, compared to \$3.9 million or \$2.20 per diluted common share for 2014. Net income available to common stockholders was impacted by the following:

Net interest income increased \$512,000 or 3.0% in 2015. This increase primarily related to an increase in interest income of \$320,000 or 1.6% and a decrease in interest expense of \$192,000 or 6.3%. Interest income for 2015 included \$145,000 of recovered interest related to the full payoff of a \$2.8 million nonperforming loan relationship and interest income for 2014 included \$533,000 of recovered interest related to the full payoff of a \$1.3 million nonperforming loan relationship. Driving the decrease in interest expense, the Corporation's cost of funds decreased 6 basis points to 0.53% for 2015 from 0.59% for 2014. Despite the impact of recovered interest and the management of funding costs, the net interest margin decreased 2 basis points to 3.33% for 2015, from 3.35% for 2014, as a result of an overall decline in asset yields.

K-22

Noninterest income was stable at \$4.1 million for the years ended December 31, 2015 and 2014. Net gains realized on the sale of securities increased \$96,000, or 12.7%, to \$854,000 in 2015 from \$758,000 in 2014, while fees and service charges decreased \$119,000.

Noninterest expense increased \$578,000, or 3.7%, to \$16.2 million for the year ended December 31, 2015 from \$15.6 million for 2014. The increase primarily related to increases in compensation and benefits, premises and equipment and professional fees of \$584,000, \$164,000 and \$263,000, respectively.

### **Changes in Financial Condition**

Total assets increased \$18.7 million, or 3.2%, to \$600.6 million at December 31, 2015 from \$581.9 million at December 31, 2014. This increase primarily related to an increase in net loans receivable of \$50.2 million. The loan growth and an \$11.9 million decrease in deposits was funded by a \$36.9 million decrease in securities and a \$27.8 million increase in borrowed funds.

**Cash and cash equivalents.** Cash and cash equivalents decreased \$310,000, or 2.6%, to \$11.5 million at December 31, 2015 from \$11.9 million at December 31, 2014. This decrease primarily resulted from the funding of loans and customer deposit withdrawals, partially offset by an increase in cash related to the sale of investment securities and borrowed funds advances. Typically, cash accounts are increased by net operating results, deposits by customers into savings and checking accounts, loan and security repayments and proceeds from borrowed funds. Decreases result from customer deposit withdrawals, new loan originations or other loan fundings, security purchases, repayments of borrowed funds and cash dividends to stockholders.

**Securities.** Securities decreased \$36.9 million, or 24.6%, to \$113.0 million at December 31, 2015 from \$149.9 million at December 31, 2014. This decrease primarily resulted from investment security sales and calls totaling \$36.1 million and \$17.3 million, respectively, offset by purchases totaling \$27.8 million during the year.

**Loans receivable.** Net loans receivable increased \$50.2 million, or 13.2%, to \$429.9 million at December 31, 2015 from \$379.6 million at December 31, 2014. The increase was driven by growth in the Corporation's residential mortgage, commercial mortgage and commercial business portfolios of \$32.1 million, \$18.9 million and \$1.8 million, respectively, partially offset by decreases in the home equity and consumer portfolios of \$1.7 million and \$856,000, respectively. The growth of the Corporation's residential mortgage portfolio included loan pool purchases totaling \$19.2 million.

**Nonperforming assets.** Nonperforming assets include nonaccrual loans, loans 90 days past due and still accruing, repossessions and real estate owned. Nonperforming assets were \$3.2 million, or 0.54% of total assets, at December 31, 2015 compared to \$7.1 million, or 1.21% of total assets, at December 31, 2014. Nonperforming assets consisted of

nonperforming loans and real estate owned of \$3.1 million and \$160,000, respectively, at December 31, 2015 and \$6.9 million and \$124,000, respectively, at December 31, 2014. This decrease in nonperforming loans was primarily due to the payoff of three nonperforming loan relationships totaling \$4.7 million and the return of one previously nonperforming loan relationship totaling \$447,000 to accrual status, partially offset by loan relationships of \$1.0 million and \$398,000 being placed on nonaccrual status during the year. At December 31, 2015, nonperforming loans consisted primarily of residential mortgage, commercial mortgage and commercial business loans.

**Federal bank stocks.** Federal bank stocks were comprised of FHLB stock and FRB stock of \$3.2 million and \$1.0 million, respectively, at December 31, 2015. These stocks are purchased and redeemed at par as directed by the federal banks and levels maintained are based primarily on borrowing and other correspondent relationships between the Corporation and the banks.

K-23

**Bank-owned life insurance (BOLI).** The Corporation maintains single premium life insurance policies on certain current and former officers and employees of the Bank. In addition to providing life insurance coverage, whereby the Bank as well as the officers and employees receive life insurance benefits, the appreciation of the cash surrender value of the BOLI will serve to offset and finance existing and future employee benefit costs. Increases in this account are typically associated with an increase in the cash surrender value of the policies, partially offset by certain administrative expenses. BOLI increased \$328,000, or 3.1%, to \$11.1 million at December 31, 2015 from \$10.7 million at December 31, 2014.

**Premises and equipment.** Premises and equipment increased \$970,000, or 6.4%, to \$16.1 million at December 31, 2015 from \$15.1 million at December 31, 2014. The overall increase in premises and equipment during the year was due to capital expenditures of \$2.0 million, partially offset by depreciation and amortization of \$1.0 million. Capital expenditures for 2015 included the purchase of equipment and software related to disaster recovery and mainframe upgrades and costs associated with the remodeling of two branch banking offices.

**Goodwill.** Goodwill was \$3.7 million at December 31, 2015 and 2014. Goodwill is evaluated for impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. Management evaluated goodwill and concluded that no impairment existed at December 31, 2015.

**Core deposit intangible.** The core deposit intangible was \$554,000 at December 31, 2015. In connection with the assumption of deposits in the 2009 Titusville branch acquisition, the Corporation recorded a core deposit intangible of \$2.8 million. This asset represents the long-term value of the core deposits acquired. Fair value was determined using a third-party valuation expert specializing in estimating fair values of core deposit intangibles. The fair value was derived using an industry standard financial instrument present value methodology. All-in costs and runoff balances by year were discounted by comparable term FHLB advance rates, used as an alternative cost of funds measure. This intangible asset amortizes utilizing the double declining balance method of amortization over a weighted average estimated life of nine years. The core deposit intangible asset is not estimated to have a significant residual value. The Corporation recorded \$195,000 and \$216,000 of intangible amortization in 2015 and 2014, respectively.

**Deposits.** Total deposits decreased \$11.9 million to \$489.9 million at December 31, 2015 from \$501.8 million at December 31, 2014. Noninterest bearing deposits increased \$8.5 million, or 7.7%, during the year while interest bearing deposits decreased \$20.4 million, or 5.2%. The deposit decline was due in part to municipal customers drawing down deposit accounts due to their not receiving timely payments of anticipated government funding as a result of the Pennsylvania budget impasse.

**Borrowed funds.** Borrowed funds increased \$27.8 million to \$49.3 million at December 31, 2015 from \$21.5 million at December 31, 2014. Borrowed funds at December 31, 2015 consisted of short-term borrowings of \$14.3 million and long-term borrowings of \$35.0 million. Long-term advances were utilized primarily to fund loan growth and

short-term advances were utilized primarily to compensate for the abnormal year-end deposit decreases.

**Accrued expenses and other liabilities.** Accrued expenses and other liabilities decreased \$2.0 million to \$8.4 million at December 31, 2015 from \$10.4 million at December 31, 2014. The Corporation's pension obligation decreased \$2.6 million to \$806,000 at December 31, 2015 from \$3.4 million at December 31, 2014 as the Corporation made a \$3.0 million cash contribution to the plan during the year.

**Stockholders' equity.** Stockholders' equity increased \$4.8 million, or 10.1%, to \$52.8 million at December 31, 2015 from \$48.0 million at December 31, 2014. The increase primarily related to an \$8.2 million private placement common stock offering completed during the second quarter of 2015 and a \$2.2 million increase in retained earnings as a result of net income totaling \$4.2 million less dividends paid of \$1.9 million. These increases were partially offset by a \$5.0 million redemption of preferred stock and a \$764,000 decrease in accumulated other comprehensive income resulting from changes in the net unrealized losses on securities available for sale and the funded status of the Corporation's defined benefit plan.



**Changes in Results of Operations**

The Corporation reported net income before preferred stock dividends of \$4.2 million and \$4.0 million in 2015 and 2014, respectively. The following “Average Balance Sheet and Yield/Rate Analysis” and “Analysis of Changes in Net Interest Income” tables should be utilized in conjunction with the discussion of the interest income and interest expense components of net interest income.

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

(Dollar amounts in thousands)	Year ended December 31,					
	2015			2014		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:						
Loans, taxable	\$375,164	\$16,706	4.45 %	\$341,183	\$16,280	4.77 %
Loans, tax-exempt	25,535	1,244	4.87 %	22,619	1,140	5.04 %
Total loans receivable	400,699	17,950	4.48 %	363,802	17,420	4.79 %
Securities, taxable	107,009	1,965	1.84 %	106,282	1,958	1.84 %
Securities, tax-exempt	31,879	1,126	3.53 %	34,378	1,394	4.06 %
Total securities	138,888	3,091	2.23 %	140,660	3,352	2.38 %
Interest-earning deposits with banks	12,328	68	0.55 %	29,359	92	0.31 %
Federal bank stocks	2,419	164	6.78 %	2,832	145	5.12 %
Total interest-earning cash equivalents	14,747	232	1.57 %	32,191	237	0.74 %
Total interest-earning assets	554,334	21,273	3.84 %	536,653	21,009	3.91 %
Cash and due from banks	2,440			2,251		
Other noninterest-earning assets	34,347			31,318		
Total Assets	\$591,121			\$570,222		
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$272,582	412	0.15 %	\$265,516	409	0.15 %
Time deposits	118,701	1,732	1.46 %	119,808	1,939	1.62 %
Total interest-bearing deposits	391,283	2,144	0.55 %	385,324	2,348	0.61 %
Borrowed funds, short-term	6,284	87	1.38 %	3,581	98	2.72 %
Borrowed funds, long-term (1)	15,205	604	3.97 %	15,836	581	3.67 %

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Total borrowed funds	21,489	691	3.21 %	19,417	679	3.49 %
Total interest-bearing liabilities	412,772	2,835	0.69 %	404,741	3,027	0.75 %
Noninterest-bearing demand deposits	117,455	-	-	112,243	-	-
Funding and cost of funds	530,227	2,835	0.53 %	516,984	3,027	0.59 %
Other noninterest-bearing liabilities	8,254			5,828		
Total Liabilities	538,481			522,812		
Stockholders' Equity	52,640			47,410		
Total Liabilities and Stockholders' Equity	\$591,121			\$570,222		
Net interest income		\$18,438			\$17,982	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			3.15 %			3.16 %
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			3.33 %			3.35 %

(1) Interest on long-term borrowed funds for the period ended December 31, 2014 was reduced by \$53,000 related to capitalized interest costs on construction in progress.

K-25

**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 rate (change in rate multiplied by prior year volume), changes in volume (changes in volume multiplied by prior year rate) 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)	2015 versus 2014		
	Increase (decrease) due to		
	Volume	Rate	Total
<b>Interest income:</b>			
Loans	\$ 1,697	\$(1,167)	\$ 530
Securities	(42 )	(219 )	(261 )
Interest-earning deposits with banks	(71 )	47	(24 )
Federal bank stocks	(23 )	42	19
<b>Total interest-earning assets</b>	<b>1,561</b>	<b>(1,297)</b>	<b>264</b>
<b>Interest expense:</b>			
Deposits	36	(240 )	(204 )
Borrowed funds, short term	52	(63 )	(11 )
Borrowed funds, long term	(24 )	47	23
<b>Total interest-bearing liabilities</b>	<b>64</b>	<b>(256 )</b>	<b>(192)</b>
<b>Net interest income</b>	<b>\$ 1,497</b>	<b>\$(1,041)</b>	<b>\$ 456</b>

#### *2015 Results Compared to 2014 Results*

The Corporation reported net income before preferred stock dividends of \$4.2 million and \$4.0 million for 2015 and 2014, respectively. The \$137,000, or 3.4%, increase in net income was attributed to increases in net interest income and noninterest income of \$512,000 and \$7,000, respectively, and a decrease in provision for loan losses of \$289,000, partially offset by increases in noninterest expense and the provision for income taxes of \$578,000 and \$93,000, respectively. Returns on average equity and assets were 7.89% and 0.70%, respectively, for 2015.

**Net interest income.** The primary source of the Corporation's revenue is net interest income. Net interest income is the difference between interest income on earning assets such as loans and securities, and interest expense on liabilities, such as deposits and borrowed funds, used to fund the earning assets. Net interest income is impacted by

the volume and composition of interest-earning assets and interest-bearing liabilities, and changes in the level of interest rates. Tax equivalent net interest income increased \$456,000 to \$18.4 million for 2015, compared to \$18.0 million for 2014. This increase in net interest income can be attributed to an increase in tax equivalent interest income of \$264,000 and a decrease in interest expense of \$192,000.

**Interest income.** Tax equivalent interest income increased \$264,000, or 1.3%, to \$21.3 million for 2015, compared to \$21.0 million for 2014. This increase can be attributed to increases in interest earned on loans and dividends received on federal bank stocks of \$530,000 and \$19,000, respectively, partially offset by decreases in securities and interest earning cash equivalents of \$261,000 and \$24,000, respectively.

Tax equivalent interest earned on loans receivable increased \$530,000, or 3.0%, to \$18.0 million for 2015, compared to \$17.4 million for 2014. The average balance of loans increased \$36.9 million, or 10.1%, generating \$1.7 million of additional interest income on loans. Offsetting this favorable variance, the average yield on loans decreased 31 basis points to 4.48% for 2015, versus 4.79% for 2014 causing a \$1.2 million decrease in interest income.

K-26

Tax equivalent interest earned on securities decreased \$261,000, or 7.8%, to \$3.1 million for 2015 compared to \$3.4 million for 2014. The average balance of securities decreased \$1.8 million, or 1.3%, causing a \$42,000 decrease in interest income. Also contributing to the unfavorable variance, the average yield on securities decreased 15 basis points to 2.23% for 2015 versus 2.38% for 2014 causing a \$219,000 decrease in interest income.

Interest earned on interest-earning deposit accounts decreased \$24,000, or 26.1%, to \$68,000 for 2015 compared to \$92,000 for 2014. The average balance of interest-earning deposits decreased \$17.0 million causing a \$71,000 decrease in interest income. Offsetting this unfavorable variance, the average yield on these accounts increased 24 basis points to 55 basis points for 2015 versus 31 basis points for 2014 generating \$20,000 on additional interest income.

Interest earned on federal bank stocks increased \$19,000, or 13.1%, to \$164,000 for 2015 compared to \$145,000 for 2014. The average yield on these accounts increased 166 basis points to 6.78% for 2015 versus 5.12% for 2014 generating a \$42,000 increase in interest income. Offsetting this favorable yield variance, average federal bank stocks decreased \$413,000, or 14.6%, causing a \$23,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$192,000, or 6.3%, to \$2.8 million for 2015 compared to \$3.0 million for 2014. This decrease can be attributed to a decrease in interest expense on interest-bearing deposits of \$204,000, partially offset by an increase in interest expense on borrowed funds of \$12,000.

Interest expense on deposits decreased \$204,000, or 8.7%, to \$2.1 million for 2015 compared to \$2.3 million for 2014. The average rate on interest-bearing deposits decreased by 6 basis points to 0.55% for 2015 versus 0.61% for 2014 causing a \$240,000 decrease in interest expense. Offsetting this favorable variance, the average balance of interest-bearing deposits increased \$6.0 million, or 1.5%, causing a \$36,000 increase in interest expense.

Interest expense on borrowed funds increased \$12,000, or 1.8%, to \$691,000 for 2015 compared to \$679,000 for 2014. The average balance of borrowed funds increased \$2.1 million, or 10.7%, to \$21.5 million for 2015 compared to \$19.4 million for 2014 causing a \$28,000 increase in interest expense. Partially offsetting this favorable variance, the average cost of borrowed funds decreased 28 basis points to 3.21% for 2015 versus 3.49% for 2014 causing a \$16,000 decrease in interest expense. This was the result of the Corporation utilizing more overnight borrowed funds at a lower rate.

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition

of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of nonperforming assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

Nonperforming loans decreased \$3.9 million, or 55.8%, to \$3.1 million at December 31, 2015 from \$6.9 million at December 31, 2014. The decrease in nonperforming loans was primarily related to the payoff of three nonperforming loan relationships totaling \$4.7 million, and the return of one previously nonperforming loan relationship totaling \$447,000 to accrual status, partially offset by loan relationships of \$1.0 million and \$398,000 being placed on nonaccrual status during the year.

The provision for loan losses decreased \$289,000, or 43.1%, to \$381,000 for 2015 from \$670,000 for 2014. The Corporation's allowance for loan losses amounted to \$5.2 million, or 1.20% of the Corporation's total loan portfolio at December 31, 2015 compared to \$5.2 million or 1.36% of total loans at December 31, 2014. The allowance for loan losses, as a percentage of nonperforming loans at December 31, 2015 and 2014, was 169.6% and 75.3%, respectively. The allocation of the allowance for loan losses related to residential mortgage loans increased during the year as a result of growth in the loan portfolio, while the allocation related to commercial loans decreased as a result of the resolution of loans individually evaluated for impairment.

**Noninterest income.** Noninterest income includes revenue that is not related to interest rates, but rather to services rendered and activities conducted in the financial services industry, including fees on depository accounts, general transaction and service fees, commissions on financial services, title premiums, security and loan gains and losses, and earnings on bank-owned life insurance (BOLI). Noninterest income increased \$7,000, or 0.2%, to \$4.1 million for 2015 and 2014. This increase was primarily due to increases in gains on the sale of securities and other noninterest income of \$96,000 and \$41,000, respectively. During 2015, the Corporation realized net securities gains of \$854,000 compared to \$758,000 realized in 2014. Partially offsetting these increases in noninterest income, fees and service charges and commissions on financial services decreased by \$119,000 and \$11,000, respectively.

**Noninterest expense.** Noninterest expense increased \$578,000, or 3.7%, to \$16.2 million for 2015, compared to \$15.6 million for 2014. This increase was primarily related to increases in compensation and employee benefits, professional fees and premises and equipment expense, partially offset by decreases in intangible amortization, professional fees and FDIC insurance expense.

The largest component of noninterest expense, compensation and employee benefits, increased \$584,000, or 7.6%, to \$8.2 million for 2015 compared to \$7.6 million for 2014. This increase primarily related to an increase in benefits expense and normal wage and salary increases.

Premises and equipment expense increased \$164,000, or 6.6%, to \$2.7 million for 2015 compared to \$2.5 million for 2014. This increase primarily related to increases in expenses associated with the Bank's new branch office in Cranberry Township, Pennsylvania, which opened in May 2014 and an upgrade to the Bank's ATM fleet in the fourth quarter of 2014.

Professional fees increased \$263,000, or 38.3%, to \$950,000 for 2015 compared to \$687,000 for 2014. This increase primarily related to costs associated with merger and acquisition activities.

Other noninterest expense decreased \$412,000, or 9.9%, to \$3.8 million for 2015 compared to \$4.2 million for 2014. Included in other noninterest expense for 2014 was \$550,000 in prepayment penalties incurred in the first quarter of 2014 associated with the early retirement of a \$5.0 million FHLB long-term advance.

The Corporation recognized \$195,000 of intangible amortization in 2015 compared to \$216,000 in 2014 associated with a core deposit intangible asset of \$2.8 million that was recorded in connection with the 2009 Titusville branch acquisition.

The provision for income taxes increased \$93,000, or 8.9%, to \$1.1 million for 2015 compared to \$1.0 million for 2014 primarily due to an increase in taxable income. The difference between the statutory rate of 35% and the Corporation's effective tax rate of 21.5% for 2015 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

K-28



## **Market Risk Management**

Market risk for the Corporation consists primarily of interest rate risk exposure and liquidity risk. The Corporation 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 Corporation 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.

The primary objective of the Corporation's asset liability management function is to maximize the Corporation's net interest income while simultaneously maintaining an acceptable level of interest rate risk given the Corporation's operating environment, capital and liquidity requirements, balance sheet mix, performance objectives and overall business focus. One of the primary measures of the exposure of the Corporation's earnings to interest rate risk is the timing difference between the repricing or maturity of interest-earning assets and the repricing or maturity of its interest-bearing liabilities.

The Corporation's Board of Directors has established a Finance Committee, consisting of four outside directors, the President and Chief Executive Officer (CEO), Treasurer and Chief Financial Officer (CFO) and Principal Accounting Officer (PAO), to monitor market risk, including primarily interest rate risk. This committee, which meets at least quarterly, generally establishes and monitors the investment, interest rate risk and asset liability management policies of the Corporation.

In order to minimize the potential for adverse affects of material and prolonged changes in interest rates on the Corporation's results of operations, the Corporation's management team has implemented and continues to monitor asset liability management policies to better match the maturities and repricing terms of the Corporation's interest-earning assets and interest-bearing liabilities. Such policies have consisted primarily of (i) originating adjustable-rate mortgage loans; (ii) originating short-term secured commercial loans with the rate on the loan tied to the prime rate or reset features in which the rate changes at determined intervals; (iii) emphasizing investment in shorter-term (expected duration of five years or less) investment securities; (iv) selling longer-term (30-year) fixed-rate residential mortgage loans in the secondary market; (v) maintaining a high level of liquid assets (including securities classified as available for sale) that can be readily reinvested in higher yielding investments should interest rates rise; (vi) emphasizing the retention of lower-costing savings accounts and other core deposits; and (vii) lengthening liabilities and locking in lower borrowing rates with longer terms whenever possible.

## **Interest Rate Sensitivity Gap Analysis**

The implementation of asset and liability initiatives and strategies and compliance with related policies, combined with other external factors such as demand for the Corporation's products and economic and interest rate environments in general, has resulted in the Corporation maintaining a one-year cumulative interest rate sensitivity gap within internal policy limits of between a positive and negative 15% of total assets. The one-year interest rate sensitivity gap is identified as the difference between the Corporation's interest-earning assets that are scheduled to mature or reprice within one year and its interest-bearing liabilities that are scheduled to mature or reprice within one year.

The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within that time period. 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, or more neutral, that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

K-29

Based on certain assumptions derived from the Corporation's historical experience, at December 31, 2015, the Corporation's interest-earning assets maturing or repricing within one year totaled \$166.5 million while the Corporation's interest-bearing liabilities maturing or repricing within one year totaled \$160.2 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$6.3 million or 1.1% of total assets. At December 31, 2015, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 104.0%.

The following table presents the amounts of interest-earning assets and interest-bearing liabilities outstanding as of December 31, 2015 which are expected to mature, prepay or reprice in each of the future time periods presented:

(Dollar amounts in thousands)	Six months or less	Six months to one year	One to three years	Three to four years	Over four years	Total
Total interest-earning assets	\$ 124,553	\$ 41,989	\$ 133,414	\$ 57,041	\$ 199,887	\$ 556,884
Total interest-bearing liabilities	84,649	75,563	162,044	36,208	61,008	419,472
Interest rate sensitivity gap	\$ 39,904	\$ (33,574 )	\$ (28,630 )	\$ 20,833	\$ 138,879	\$ 137,412
Cumulative rate sensitivity gap	\$ 39,904	\$ 6,330	\$ (22,300 )	\$ (1,467 )	\$ 137,412	
Ratio of gap during the period to total interest earning assets	7.17	% (6.03)	% (5.14)	% 3.74	% 24.94	%
Ratio of cumulative gap to total interest earning assets	7.17	% 1.14	% (4.00)	% (0.26)	% 24.68	%

Although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. The ability of many borrowers to service their debt may decrease in the event of an interest rate increase.

#### *Interest Rate Sensitivity Simulation Analysis*

The Corporation also utilizes income simulation modeling in measuring its interest rate risk and managing its interest rate sensitivity. The Finance Committee of the Board of Directors believes that simulation modeling enables the Corporation to more accurately evaluate and manage the possible effects on net interest income due to the exposure to changing market interest rates and different loan and security prepayment and deposit decay assumptions under various interest rate scenarios.

As with gap analysis and earnings simulation modeling, assumptions about the timing and variability of cash flows are critical in net portfolio equity valuation analysis. Particularly important are the assumptions driving mortgage prepayments and the assumptions about expected attrition of the core deposit portfolios. These assumptions are based on the Corporation's historical experience.

The Corporation has established the following guidelines for assessing interest rate risk:

**Net interest income simulation.** Given a 200 basis point immediate increase or decrease in market interest rates, net interest income may not change by more than 15% for a one-year period.

**Economic value of equity simulation.** Economic value of equity is the present value of the Corporation's existing assets less the present value of the Corporation's existing liabilities. Given a 200 basis point immediate and permanent increase or decrease in market interest rates, economic value of equity may not correspondingly decrease or increase by more than 20%.

These guidelines take into consideration the current interest rate environment, the Corporation's financial asset and financial liability product mix and characteristics and liquidity sources among other factors. Given the current rate environment, a drop in short-term market interest rates of 200 basis points immediately or over a one-year horizon would seem unlikely. This should be considered in evaluating modeling results outlined in the table below.

The following table presents the simulated impact of a 100 basis point or 200 basis point upward or downward shift of market interest rates on net interest income for the years ended December 31, 2015 and 2014, respectively. This analysis was done assuming that the interest-earning asset and interest-bearing liability levels at December 31, 2015 remained constant. The impact of the market rate movements on net interest income was developed by simulating the effects of rates changing immediately for a one-year period from the December 31, 2015 levels for net interest income.

	Increase		Decrease	
	+100 BP	+200 BP	-100 BP	-200 BP
2015 Net interest income - increase (decrease)	(0.36)%	(1.14)%	(2.80)%	(6.67)%
2014 Net interest income - increase (decrease)	(0.26)%	(0.88)%	(3.46)%	(7.16)%

The expected decrease in net interest income in the rising rate scenarios shown in the table above resulted from the Corporation having overnight borrowings of \$14.5 million at December 31, 2015. In a rising rate environment, these borrowings would be immediately repricing, therefore causing increased interest expense.

### **Impact of Inflation and Changing Prices**

The consolidated financial statements of the Corporation and related notes presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) which require the measurement of financial condition and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Unlike most industrial companies, substantially all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services since such prices are affected by inflation to a larger degree than interest rates. In the current interest rate environment, liquidity and the maturity structure of the Corporation's assets and liabilities are critical to the maintenance of acceptable performance levels.

### **Capital Resources**

Total stockholders' equity increased \$4.8 million, or 10.1%, to \$52.8 million at December 31, 2015 from \$48.0 million at December 31, 2014. Net income before preferred stock dividends of \$4.2 million in 2015 represented an increase in earnings of \$137,000, or 3.4%, compared to 2014.

The Corporation's capital to assets ratio increased to 8.8% at December 31, 2015 from 8.3% at December 31, 2014. During the second quarter of 2015, the Corporation raised \$8.2 million in capital, net of expenses, through the issuance of 350,000 shares of common stock in a private placement offering to accredited investors. During the third quarter of 2015, the Corporation utilized a portion of the proceeds of the stock offering to redeem the remaining \$5.0 million of preferred stock issued to the U.S. Treasury under the SBLF program. While continuing to sustain a strong capital position, dividends on common stock increased to \$1.9 million in 2015 from \$1.6 million in 2014. In addition, stockholders have taken part in the Corporation's dividend reinvestment plan introduced during 2003 with 47% of registered shareholder accounts active in the plan at December 31, 2015. Dividend reinvestment is achieved through the purchase of common shares on the secondary market.

Capital adequacy is intended to enhance the Corporation's ability to support growth while protecting the interest of stockholders and depositors and to ensure that capital ratios are in compliance with regulatory minimum requirements. Regulatory agencies have developed certain capital ratio requirements that are used to assist them in monitoring the safety and soundness of financial institutions. At December 31, 2015, the Bank was in excess of all regulatory capital requirements. See Note 12 to the Corporation's consolidated financial statements attached hereto.

## **Liquidity**

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB, and amortization and prepayments of outstanding loans and maturing securities. During 2015, the Corporation used its sources of funds primarily to fund loan commitments. As of December 31, 2015, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$58.0 million, and standby letters of credit totaling \$146,000. The Bank is required by the OCC to establish policies to monitor and manage liquidity levels to ensure the Bank's ability to meet demands for customer withdrawals and the repayment of short-term borrowings, and the Bank is currently in compliance with all liquidity policy limits.

At December 31, 2015, time deposits amounted to \$113.5 million, or 23.2%, of the Corporation's total consolidated deposits, including approximately \$31.9 million scheduled to mature within the next year. Management believes that the Corporation has adequate resources to fund all of its commitments, that all of its commitments will be funded as required by related maturity dates and that, based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation and the Bank have alternative sources of funds. These sources include an unfunded \$7.5 million line of credit for the Corporation with a correspondent bank, the Bank's line of credit and term borrowing capacity from the FHLB and, to a more limited extent, through the sale of loans. At December 31, 2015, the Bank's borrowing capacity with the FHLB, net of funds borrowed and irrevocable standby letters of credit issued to secure certain deposit accounts, was \$120.6 million.

The Corporation pays a regular quarterly cash dividend. The Corporation paid dividends of \$0.24 and \$0.22 per common share for each of the four quarters of 2015 and 2014, respectively. On February 17, 2016, the Corporation declared a quarterly dividend of \$0.26 per common share payable on March 18, 2016 to shareholders of record on March 1, 2016. The determination of future dividends on the Corporation's common stock will depend on conditions existing at that time with consideration given to the Corporation's earnings, capital and liquidity needs, among other factors.

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 GAAP 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.

K-32



The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements. 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 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 security or more likely than not will be required to sell the 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. Goodwill is subject to ongoing periodic impairment tests based on the fair value of the reporting unit compared to its carrying amount, including goodwill. Impairment exists when a reporting unit's carrying amount exceeds its fair value. At November 30, 2015, the Corporation elected to perform a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeded its carrying amount, including goodwill. The qualitative assessment indicated that it was more likely than not that the fair value of the reporting unit exceeded its carrying value, resulting in no impairment. If for any future period it is determined that there has been impairment in the carrying value of our goodwill balances, the Corporation will record a charge to earnings, which could have a material adverse effect on net income, but not risk based capital ratios.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Information required by this item is included in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in item 7.

**Item 8. Financial Statements and Supplementary Data**

Information required by this item is included herein beginning on page F-1.

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

Not applicable.

K-33

**Item 9A. 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 CEO and 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 December 31, 2015, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective.

During the fourth quarter of fiscal year 2015, there has been no change made in the Corporation's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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 valuation.

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Corporation. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

**Management's Report on Internal Control Over Financial Reporting**

Management completed an assessment of the Corporation's internal control over financial reporting as of December 31, 2015. This assessment was based on criteria for evaluating internal control over financial reporting established in the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concluded that the Corporation's internal control over financial reporting was effective as of December 31, 2015.

**Item 9B. Other Information**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this item is incorporated herein by reference to the sections captioned “Principal Beneficial Owners of the Corporation’s Common Stock”, “Section 16(a) Beneficial Ownership Reporting Compliance” and “Information With Respect to Nominees For Director, Continuing Director and Executive Officers” in the Corporation’s definitive proxy statement for the Corporation’s Annual Meeting of Stockholders to be held on April 27, 2016 (the Proxy Statement).

The Corporation maintains a Code of Personal and Business Conduct and Ethics (the Code) that applies to all employees, including the CEO and the CFO. A copy of the Code has previously been filed with the SEC and is posted on our website at [www.emclairefinancial.com](http://www.emclairefinancial.com). Any waiver of the Code with respect to the CEO and the CFO will be publicly disclosed in accordance with applicable regulations.

K-34

**Item 11. Executive Compensation**

The information required by this item is incorporated herein by reference to the section captioned “Executive Compensation” in the Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item is incorporated herein by reference to the section captioned “Principal Beneficial Owners of the Corporation’s Common Stock” in the Proxy Statement.

**Equity Compensation Plan Information.** The following table provides certain information as of December 31, 2015 with respect to shares of common stock that may be issued under our equity compensation plans, which consists of the 2007 Stock Incentive Plan and Trust, which was approved by shareholders in April 2007 and the 2014 Stock Incentive Plan, which was approved by shareholders in April 2014.

Plan Category	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options (1)	Number of securities remaining available for issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	73,000	\$ 25.71	210,512
Equity compensation plans not approved by security holders	0	--	0
Total	73,000	\$ 25.71	210,512

(1) Options outstanding have been granted pursuant to the 2007 Stock Incentive Plan and Trust (Plan). The Plan provides for the grant of options to purchase up to 126,783 shares of common stock of which options to purchase 73,000 shares were outstanding at December 31, 2015. In addition, 8,500 shares of common stock have been issued

upon exercise of options. The Plan also provides for grants of up to 50,713 shares of restricted common stock of which 49,400 shares have been granted. In addition, the 2014 Stock Incentive Plan provides for the grant of options to purchase up to 88,433 shares of common stock and for grants of up to 88,433 shares of restricted common stock of which no options and 12,950 shares of restricted stock have been granted.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is incorporated herein by reference to the sections captioned “Information With Respect to Nominees For Director, Continuing Directors and Executive Officers” and “Executive Compensation” in the Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

The information required by this item is incorporated herein by reference to the section captioned “Relationship With Independent Registered Public Accounting Firm” in the Proxy Statement.

K-35

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a)(1)-(2) Financial Statements and Schedules:

(i) The financial statements required in response to this item are incorporated by reference from Item 8 of this report.

(3) Management Contracts or Compensatory Plans:

(i) Exhibits 10.1-10.7 listed below in (b) identify management contracts or compensatory plans or arrangements required to be filed as exhibits to this report, and such listing is incorporated herein by reference.

(b) Exhibits are either attached as part of this Report or incorporated herein by reference.

3.1 Articles of Incorporation of Emclaire Financial Corp (1)

3.2 Bylaws of Emclaire Financial Corp (1)

4.0 Specimen Common Stock Certificate of Emclaire Financial Corp (2)

10.1 Amended and Restated Employment Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and William C. Marsh, dated as of November 18, 2015. (3)\*

10.2 Amended and Restated Change in Control Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and Matthew J. Lucco, dated as of November 18, 2015. (3)\*

10.3 Amended and Restated Change in Control Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and Amanda L. Engles, dated as of November 18, 2015. (3)\*

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

10.4 Amended and Restated Supplemental Executive Retirement Plan Agreement between The Farmers National Bank of Emlenton and William C. Marsh, dated as of November 18, 2015. (3)\*

10.5 Amended and Restated Supplemental Executive Retirement Plan Agreement between The Farmers National Bank of Emlenton and Matthew J. Lucco, dated as of November 18, 2015. (3)\*

10.6 Group Term Carve-Out Plan between the Farmers National Bank of Emlenton and Officers and Employees. (4)\*

10.7 Farmers National Bank of Emlenton Deferred Compensation Plan. (5)\*

10.8 Emclair Financial Corp 2007 Stock Incentive Plan and Trust. (6)\*

10.9 Emclair Financial Corp 2014 Stock Incentive Plan (7)\*

11.0 Statement regarding computation of earnings per share (see Note 1 of the Notes to Consolidated Financial Statements in the Annual Report).

14.0 Code of Personal and Business Conduct and Ethics. (8)

K-36



20.0 Emclaire Financial Corp Dividend Reinvestment and Stock Purchase Plan. (9)

21.0 Subsidiaries of the Registrant (see information contained herein under “Item 1. Description of Business - Subsidiary Activity”).

31.1 Principal Executive Officer Section 302 Certification.

31.2 Principal Financial Officer Section 302 Certification.

32.1 Principal Executive Officer Section 906 Certification.

32.2 Principal Financial Officer Section 906 Certification.

101.INSXBRL Instance Document

101.SCHXBRL Taxonomy Extension Schema Document

101.CALXBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definitions Linkbase Document

101.LABXBRL Taxonomy Extension Label Linkbase Document

101.PREXBRL Taxonomy Extension Presentation Linkbase Document

\* Compensatory plan or arrangement.

(1) Incorporated by reference to the Registrant’s Registration Statement on Form SB-2, as amended, (File No. 333-11773) declared effective by the SEC on October 25, 1996.

(2) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 1997.

(3) Incorporated by reference to the Registrant’s Current Report on Form 8-K dated November 18, 2015.

(4) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2002.

(5) Incorporated by reference to the Registrant’s Current Report on Form 8-K dated December 15, 2008.

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

- (6) Incorporated by reference to the Registrant's Definitive Proxy Statement dated March 23, 2007.
- (7) Incorporated by reference to the Registrant's Definitive Proxy Statement dated March 24, 2016.
- (8) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004.
- (9) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001.

K-37

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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**

Dated: March 24, 2016 By: /s/ William C. Marsh  
William C. Marsh  
Chairman, Chief Executive Officer, President and Director  
(Duly Authorized Representative)

Pursuant to the requirement of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

By: <u>/s/ William C. Marsh</u> William C. Marsh Chairman of the Board Chief Executive Officer President Director (Principal Executive Officer)	By: /s/ Matthew J. Lucco Matthew J. Lucco Treasurer and Chief Financial Officer (Principal Financial Officer) Date: March 24, 2016
---	--

Date: March 24, 2016 By: /s/ Amanda L. Engles  
Amanda L. Engles  
Secretary  
(Principal Accounting Officer)  
Date: March 24, 2016

By: /s/ Milissa S. Bauer Milissa S. Bauer Director Date: March 24, 2016	By: /s/ David L. Cox David L. Cox Director Date: March 24, 2016
--	--

By: /s/ James M. Crooks James M. Crooks Director	By: /s/ Robert W. Freeman Robert W. Freeman Director
--	--

Date: March 24, 2016

Date: March 24, 2016

By: /s/ Mark A. Freemer  
Mark A. Freemer  
Director

By: /s/ Robert L. Hunter  
Robert L. Hunter  
Director

Date: March 24, 2016

Date: March 24, 2016

By: /s/ John B. Mason  
John B. Mason  
Director

By: /s/ Brian C. McCarrier  
Brian C. McCarrier  
Director

Date: March 24, 2016

Date: March 24, 2016

By: /s/ Nicholas D. Varischetti  
Nicholas D. Varischetti  
Director

Date: March 24, 2016

K-38

**Financial Statements**

**Table of Contents**

<u>Report of Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated Balance Sheets</u>	F-3
<u>Consolidated Statements of Net Income</u>	F-4
<u>Consolidated Statements of Comprehensive Income</u>	F-5
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	F-6
<u>Consolidated Statements of Cash Flows</u>	F-7
<u>Notes to Consolidated Financial Statements</u>	F-8

F-1

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders

Emclaire Financial Corp

Emlenton, Pennsylvania

We have audited the accompanying consolidated balance sheets of Emclaire Financial Corp as of December 31, 2015 and 2014, and the related consolidated statements of net income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Emclaire Financial Corp as of December 31, 2015 and 2014, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ Crowe Horwath LLP

Cleveland, Ohio

March 24, 2016



**Consolidated Balance Sheets***(Dollar amounts in thousands, except share and per share data)*

	December 31,	
	2015	2014
Assets		
Cash and due from banks	\$2,359	\$2,386
Interest earning deposits with banks	9,187	9,470
Total cash and cash equivalents	11,546	11,856
Securities available for sale	112,981	149,861
Loans receivable, net of allowance for loan losses of \$5,205 and \$5,224	429,891	379,648
Federal bank stocks, at cost	4,240	2,406
Bank-owned life insurance	11,056	10,728
Accrued interest receivable	1,501	1,543
Premises and equipment, net	16,114	15,144
Goodwill	3,664	3,664
Core deposit intangible, net	554	749
Prepaid expenses and other assets	9,048	6,310
Total Assets	\$600,595	\$581,909
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Non-interest bearing	\$119,790	\$111,282
Interest bearing	370,097	390,537
Total deposits	489,887	501,819
Borrowed funds	49,250	21,500
Accrued interest payable	179	199
Accrued expenses and other liabilities	8,440	10,401
Total Liabilities	547,756	533,919
Commitments and Contingent Liabilities (Note 13)		
Stockholders' Equity		
Preferred stock, \$1.00 par value, 3,000,000 shares authorized; Series B, non-cumulative preferred stock, \$0 and \$5,000 liquidation value, no shares and 5,000 shares issued and outstanding	-	5,000
Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,246,825 and 1,882,675 shares issued; 2,144,808 and 1,780,658 shares outstanding	2,808	2,353
Additional paid-in capital	27,701	19,740
Treasury stock, at cost; 102,017 shares	(2,114 )	(2,114 )
Retained earnings	28,206	26,009
Accumulated other comprehensive loss	(3,762 )	(2,998 )
Total Stockholders' Equity	52,839	47,990
Total Liabilities and Stockholders' Equity	\$600,595	\$581,909



See accompanying notes to consolidated financial statements.

F-3

**Consolidated Statements of Net Income***(Dollar amounts in thousands, except share and per share data)*

	Year ended December 31,	
	2015	2014
Interest and dividend income		
Loans receivable, including fees	\$ 17,578	\$ 17,078
Securities:		
Taxable	1,965	1,958
Exempt from federal income tax	807	989
Federal bank stocks	164	145
Deposits with banks	68	92
Total interest and dividend income	20,582	20,262
Interest expense		
Deposits	2,144	2,348
Short-term borrowed funds	87	98
Long-term borrowed funds	604	581
Total interest expense	2,835	3,027
Net interest income	17,747	17,235
Provision for loan losses	381	670
Net interest income after provision for loan losses	17,366	16,565
Noninterest income		
Fees and service charges	1,477	1,596
Commissions on financial services	24	35
Title premiums	53	58
Net gain on sales of available for sale securities	854	758
Earnings on bank-owned life insurance	396	391
Other	1,290	1,249
Total noninterest income	4,094	4,087
Noninterest expense		
Compensation and employee benefits	8,223	7,639
Premises and equipment	2,651	2,487
Intangible asset amortization	195	216
Professional fees	950	687
Federal deposit insurance	376	376
Other	3,770	4,182
Total noninterest expense	16,165	15,587
Income before provision for income taxes	5,295	5,065
Provision for income taxes	1,141	1,048
Net income	4,154	4,017
Preferred stock dividends	75	100
Net income available to common stockholders	\$ 4,079	\$ 3,917
Earnings per common share		
Basic	\$ 2.06	\$ 2.21
Diluted	\$ 2.05	\$ 2.20

See accompanying notes to consolidated financial statements.

F-4

**Consolidated Statements of Comprehensive Income***(Dollar amounts in thousands)*

	Year ended December 31,	
	2015	2014
Net income	\$ 4,154	\$ 4,017
Other comprehensive income (loss)		
Unrealized gains/(losses) on securities:		
Unrealized holding gain arising during the period	179	3,892
Reclassification adjustment for gains included in net income	(854 )	(758 )
	(675 )	3,134
Tax effect	229	(1,066 )
Net of tax	(446 )	2,068
Defined benefit pension plans:		
Net loss arising during the period	(657 )	(2,764 )
Reclassification adjustment for amortization of prior service benefit and net loss included in net periodic pension cost	174	58
	(483 )	(2,706 )
Tax effect	165	920
Net of tax	(318 )	(1,786 )
Total other comprehensive income (loss)	(764 )	282
Comprehensive income	\$ 3,390	\$ 4,299

See accompanying notes to consolidated financial statements.

**Consolidated Statements of Changes in Stockholders' Equity***(Dollar amounts in thousands, except share and per share data)*

	Preferred Stock	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at January 1, 2014	\$ 5,000	\$ 2,338	\$ 19,478	\$(2,114 )	\$23,650	\$ (3,280 )	\$ 45,072
Net income					4,017		4,017
Other comprehensive income						282	282
Stock compensation expense			198				198
Exercise of stock options (2,500 shares), including tax benefit		3	49				52
Issuance of common stock for restricted stock awards (9,500 shares), including tax benefit		12	15				27
Preferred dividends					(100 )		(100 )
Cash dividends declared on common stock (\$0.88 per share)					(1,558 )		(1,558 )
Balance at December 31, 2014	5,000	2,353	19,740	(2,114 )	26,009	(2,998 )	47,990
Net income					4,154		4,154
Other comprehensive loss						(764 )	(764 )
Stock compensation expense			184				184
Exercise of stock options (3,750 shares), including tax benefit		5	60				65
Issuance of common stock (350,000 shares)		437	7,714				8,151
Issuance of common stock for restricted stock awards (10,400 shares), including tax benefit		13	3				16
Redemption of preferred stock, Series B	(5,000 )						(5,000 )
Preferred dividends					(75 )		(75 )
Cash dividends declared on common stock (\$0.96 per share)					(1,882 )		(1,882 )
Balance at December 31, 2015	\$ -	\$ 2,808	\$ 27,701	\$(2,114 )	\$28,206	\$ (3,762 )	\$ 52,839

See accompanying notes to consolidated financial statements.

**Consolidated Statements of Cash Flows***(Dollar amounts in thousands, except share and per share data)*

	Year ended December 31,	
	2015	2014
Cash flows from operating activities		
Net income	\$ 4,154	\$ 4,017
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	1,039	871
Provision for loan losses	381	670
Amortization/accretion of premiums, discounts and deferred costs and fees, net	362	252
Amortization of intangible assets and mortgage servicing rights	196	216
Realized gains on sales of available for sale securities, net	(854 )	(758 )
Net gains on foreclosed real estate	(15 )	(12 )
Net gains on sales of bank premises and equipment	-	(15 )
Write-down of foreclosed real estate	13	-
Restricted stock and stock option compensation	184	198
Increase in bank-owned life insurance, net	(328 )	(327 )
(Increase) decrease in accrued interest receivable	42	(77 )
Decrease in deferred taxes	1,146	25
(Increase) decrease in prepaid expenses and other assets	(3,619 )	203
Decrease in accrued interest payable	(20 )	(93 )
Increase in accrued expenses and other liabilities	738	355
Net cash provided by operating activities	3,419	5,525
Cash flows from investing activities		
Loan originations and principal collections, net	(27,836 )	(25,273 )
Purchase of residential mortgage loans	(19,481 )	-
Settlement of syndicated national credits	(7,039 )	-
Available for sale securities:		
Sales	36,314	24,452
Maturities, repayments and calls	27,873	14,813
Purchases	(27,117 )	(67,923 )
Redemption (purchase) of federal bank stocks, net	(1,834 )	1,571
Proceeds from the sale of bank premises and equipment	-	45
Purchases of premises and equipment	(2,009 )	(3,735 )
Proceeds from the sale of foreclosed real estate	307	139
Net cash used in investing activities	(20,822 )	(55,911 )
Cash flows from financing activities		
Net increase (decrease) in deposits	(11,932 )	69,813
Proceeds from Federal Home Loan Bank advances	20,000	-
Repayments on Federal Home Loan Bank advances	-	(5,000 )
Net change in short-term borrowings	7,750	(17,650 )
Proceeds from issuance of common stock	8,151	-
Redemption of preferred stock (Series B)	(5,000 )	-
Proceeds from exercise of stock options, including tax benefit	81	79

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Dividends paid	(1,957 )	(1,658 )
Net cash provided by financing activities	17,093	45,584
Net decrease in cash and cash equivalents	(310 )	(4,802 )
Cash and cash equivalents at beginning of period	11,856	16,658
Cash and cash equivalents at end of period	\$ 11,546	\$ 11,856
Supplemental information:		
Interest paid	\$ 2,855	\$ 3,120
Income taxes paid	525	515
Supplemental noncash disclosures:		
Transfers from loans to foreclosed real estate	341	144
Syndicated national credits settled in subsequent period	-	3,018

See accompanying notes to consolidated financial statements.

F-7

## Notes to Consolidated Financial Statements

### 1. Summary of Significant Accounting Policies

***Basis of Presentation and Consolidation.*** The consolidated financial statements include the accounts of Emclaire Financial Corp (the Corporation) and its wholly owned subsidiaries, The Farmers National Bank of Emlenton (the Bank) and Emclaire Settlement Services, LLC (the Title Company). All significant intercompany balances and transactions have been eliminated in consolidation.

***Nature of Operations.*** 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.

***Use of Estimates and Classifications.*** In preparing consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts previously reported may have been reclassified to conform to the current year financial statement presentation. Such reclassifications did not affect net income or stockholders' equity.

***Significant Group Concentrations of Credit Risk.*** Most of the Corporation's activities are with customers located within the Western Pennsylvania region of the country. Note 4 discusses the type of securities that the Corporation invests in. Note 5 discusses the types of lending the Corporation engages in. The Corporation does not have any significant concentrations to any one industry or customer.

***Cash and Cash Equivalents.*** For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, cash items, interest-earning deposits with other financial institutions and federal funds sold and due from correspondent banks. Interest-earning deposits are generally short-term in nature and are carried at cost. Federal funds are generally sold or purchased for one day periods. Net cash flows are reported for loan and deposit transactions, short term borrowings and purchases and redemptions of federal bank stocks.

***Dividend Restrictions.*** Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Corporation or by the Corporation to stockholders.



***Securities Available for Sale.*** Debt securities are classified as available for sale when they might be sold before maturity. Equity securities with readily determinable fair values are classified as available for sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income from securities includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized using the level yield method over the term of the securities. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

F-8

## Notes to Consolidated Financial Statements (continued)

### 1. Summary of Significant Accounting Policies (continued)

**Securities (continued).** Management evaluates securities for other-than-temporary impairment (OTTI) 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 security or more likely than not will be required to sell the security before the 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 through earnings. 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.

**Loans Receivable.** The Corporation grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by loans collateralized by real estate located throughout Western Pennsylvania. The ability of the Corporation's debtors to honor their contracts is dependent upon real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans or premiums or discounts on purchased loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, and premiums and discounts are deferred and recognized in interest income as an adjustment of the related loan yield using the interest method.

The accrual of interest on all classes of loans is typically discontinued at the time the loan is 90 days past due unless the credit is well secured and in the process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified as impaired loans. All interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for a return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

***Allowance for Loan Losses.*** The allowance for loan losses is established for probable incurred credit losses through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are typically credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historic experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, prevailing economic conditions and other factors. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

## Notes to Consolidated Financial Statements (continued)

### 1. Summary of Significant Accounting Policies (continued)

**Allowance for Loan Losses (continued).** A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings (TDR) and classified as impaired.

Factors considered by management in determining impairment on all loan classes include demonstrated ability to repay, payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impairment is measured on a loan by loan basis for commercial loans by either the present value of expected future cash flows discounted at the loans effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of small balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

TDR's are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of collateral. For TDR's that subsequently default, the Corporation determines the amount of reserves in accordance with accounting policies for the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Corporation over the prior 12 quarters. Qualitative factors considered by management include national and local economic and business conditions, changes in the nature and volume of the loan portfolio, quality of loan review systems, and changes in trends, volume and severity of past due, nonaccrual and classified loans, and loss and recovery trends. The Corporation's portfolio segments are as follows:

Residential mortgages Residential mortgage loans are loans to consumers utilized for the purchase, refinance or construction of a residence. Changes in interest rates or market conditions may impact a borrower's ability to meet contractual principal and interest payments.

Home equity loans and lines of credit Home equity loans and lines of credit are credit facilities extended to homeowners who wish to utilize the equity in their property in order to borrow funds for almost any consumer purpose. Property values may fluctuate in value due to economic and other factors.

F-10

## Notes to Consolidated Financial Statements (continued)

### 1. Summary of Significant Accounting Policies (continued)

**Commercial real estate** Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans. These loans are viewed primarily as cash flow loans and the repayment of these loans is largely dependent on the successful operation of the property. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to real estate markets such as geographic location and property type.

**Commercial business** Commercial credit is extended to business customers for use in normal operations to finance working capital needs, equipment purchases or other projects. The majority of these borrowers are customers doing business within our geographic region. These loans are generally underwritten individually and secured with the assets of the company and the personal guarantee of the business owners. Commercial loans are made based primarily on the historical and projected cash flow of the borrower and the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not behave as forecasted and collateral securing loans may fluctuate in value due to economic or individual performance factors.

**Consumer** Consumer loans are loans to an individual for non-business purposes such as automobile purchases or debt consolidation. These loans are originated based primarily on credit scores and debt-to-income ratios which may be adversely affected by economic or individual performance factors.

**Loans Held for Sale.** Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Mortgage loans held for sale are generally sold with servicing retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgages are based on the difference between the selling price and the carrying value of the related loan sold.

**Federal Bank Stocks.** The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB) and the Federal Reserve Bank of Cleveland (FRB). As a member of these federal banking systems, the Bank maintains an investment in the capital stock of the respective regional banks, at cost and classified as restricted stock. These stocks are purchased and redeemed at par as directed by the federal banks and levels maintained are based primarily on borrowing and other correspondent relationships. These stocks are periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

**Bank-Owned Life Insurance (BOLI).** The Bank purchased life insurance policies on certain key officers and employees. BOLI is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

**Premises and Equipment.** Land is carried at cost. Premises, furniture and equipment, and leasehold improvements are carried at cost less accumulated depreciation or amortization. Depreciation is calculated on a straight-line basis over the estimated useful lives of the related assets, which are twenty-five to forty years for buildings and three to ten years for furniture and equipment. Amortization of leasehold improvements is computed using the straight-line method over the shorter of their estimated useful life or the expected term of the leases. Expected terms include lease option periods to the extent that the exercise of such option is reasonably assured. Premises and equipment are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, assets are recorded at fair value.

F-11

Notes to Consolidated Financial Statements (continued)

1. Summary of Significant Accounting Policies (continued)

**Goodwill and Intangible Assets.** Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired assets and liabilities. Core deposit intangible assets arise from whole bank or branch acquisitions and are measured at fair value and then are amortized over their estimated useful lives. Customer relationship intangible assets arise from the purchase of a customer list from another company or individual and then are amortized on a straight-line basis over two years. Goodwill is not amortized but is assessed at least annually for impairment. Any such impairment will be recognized in the period identified. The Corporation has selected November 30 as the date to perform the annual impairment test. Goodwill is the only intangible asset with an indefinite life on the Corporation's balance sheet.

**Servicing Assets.** Servicing assets represent the allocated value of retained servicing rights on loans sold. Servicing assets are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the assets, using groupings of the underlying loans as to interest rates. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment of a grouping is reported as a valuation allowance, to the extent that fair value is less than the capitalized amount for a grouping.

**Other Real Estate Acquired Through Foreclosure (OREO).** Real estate properties acquired through foreclosure are initially recorded at fair value less cost to sell when acquired, thereby establishing a new cost basis for the asset. These assets are subsequently accounted for at the lower of carrying amount or fair value less cost to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Revenue and expenses from operations of the properties, gains and losses on sales and additions to the valuation allowance are included in operating results. Real estate acquired through foreclosure is classified in prepaid expenses and other assets and totaled \$160,000 and \$124,000 at December 31, 2015 and 2014, respectively. Loans secured by residential real estate properties for which formal foreclosure proceedings are in process totaled \$1.3 million and \$863,000 at December 31, 2015 and 2014, respectively.

**Treasury Stock.** Common stock purchased for treasury is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on the first-in, first-out basis.

**Income Taxes.** Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. A tax



position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.

***Earnings Per Common Share (EPS)***. Basic EPS excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS includes the dilutive effect of additional potential common shares issuable under stock options and restricted stock awards.

**Notes to Consolidated Financial Statements (continued)**

**1. Summary of Significant Accounting Policies (continued)**

**Comprehensive Income.** Comprehensive income includes net income and other comprehensive income. Other comprehensive income (loss) is comprised of unrealized holding gains and losses on securities available for sale and changes in the funded status of pension which are also recognized as separate components of equity.

**Operating Segments.** Operations are managed and financial performance is evaluated on a corporate-wide basis. Accordingly, all financial services operations are considered by management to be aggregated in one reportable operating segment.

**Retirement Plans.** The Corporation maintains a noncontributory defined benefit plan covering eligible employees and officers. Effective January 1, 2009 the plan was closed to new participants. The Corporation provided the requisite notice to plan participants on March 12, 2013 of the determination to freeze the plan (curtailment). While the freeze was not effective until April 30, 2013, the Corporation determined that participants would not satisfy, within the provisions of the plan, 2013 eligibility requirements based on minimum hours worked for 2013. Therefore, employees ceased to earn benefits as of January 1, 2013. This amendment to the plan will not affect benefits earned by the participant prior to the date of the freeze. The Corporation also maintains a 401(k) plan, which covers substantially all employees, and a supplemental executive retirement plan for key executive officers.

**Stock Compensation Plans.** Compensation expense is recognized for stock options and restricted stock awards issued based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation expense is recognized over the required service period, generally defined as the vesting period. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.

**Transfers of Financial Assets.** Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

***Off-Balance Sheet Financial Instruments.*** In the ordinary course of business, the Corporation has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commitments under line of credit lending arrangements and letters of credit. Such financial instruments are recorded in the financial statements when they are funded.

***Fair Value of Financial Instruments.*** Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

## Notes to Consolidated Financial Statements (continued)

### 1. Summary of Significant Accounting Policies (continued)

**Loss Contingencies.** Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there currently are such matters that will have a material effect on the financial statements.

**Recent Accounting Standards.** In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 “Revenue from Contracts with Customers”. ASU 2014-09 provides guidance that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of this standard to annual and interim periods beginning after December 15, 2017; however, early adoption is permitted for annual and interim reporting periods beginning after December 15, 2016. The Corporation is currently evaluating the impact ASU 2014-09 will have on its financial statements.

In June 2014, the FASB issued ASU 2014-11 “Transfers and Servicing (Topic 860). ASU 2014-11 amends the accounting guidance for repo-to-maturity transactions and requires such transactions to be accounted for as secured borrowings. In addition, ASU 2014-11 requires enhanced disclosures related to the collateral pledged, maturity and risk associated with repurchase agreements. ASU 2014-11 did not have a significant impact on the Corporation’s financial statements.

In January 2015, the FASB issued ASU 2015-01 “Income Statement – Extraordinary and Unusual Items (Subtopic 225-20) – Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items”. ASU 2015-01 eliminates from GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 is effective for interim and annual periods beginning after December 15, 2015. ASU 2015-01 is not expected to have a significant impact on the Corporation’s financial statements.

In February 2015, the FASB issued ASU 2015-02 “Consolidation (Topic 810): Amendments to the Consolidation Analysis” which amends the consolidation requirements of ASU 810 by changing the consolidation analysis required under GAAP. The reviewed guidance amends the consolidation analysis based on certain fee arrangements or relationships to the reporting entity and for limited partnerships requires entities to consider the limited partners’ rights relative to the general partner. ASU 2015-02 is effective for annual and interim periods beginning after December 15,

2015. ASU 2015-02 is not expected to have a significant impact on the Corporation's financial statements.

In April 2015, the FASB issued ASU 2015-03 "Interest – Imputation of Interest (Subtopic 835-30) – Simplifying the Presentation of Debt Issuance Costs". ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in ASU 2015-03. In August 2015, the FASB issued 2015-15 to clarify the SEC staff's position on presenting and measuring debt issue costs related to line-of-credit arrangements. ASU 2015-03 and ASU 2015-15 are not expected to have a significant impact on the Corporation's financial statements.

**Notes to Consolidated Financial Statements (continued)**

**1. Summary of Significant Accounting Policies (continued)**

In September 2015, the FASB issued ASU 2015-16 “Simplifying the Accounting for Measurement-Period Adjustments”. ASU 2015-16 requires entities to recognize measurement period adjustments during the reporting period in which the adjustments are determined. The income effects of a measurement period adjustment are cumulative and are to be reported in the period in which the adjustment to a provisional amount is determined. ASU 2015-16 also requires presentation on the face of the income statement or in the notes the effect of the measurement period adjustment as if the adjustment had been recognized at acquisition date. ASU 2015-16 is effective for fiscal periods after December 15, 2016 and should be applied prospectively to measurement period adjustments that occur after the effective date.

In January 2016, the FASB issued ASU 2016-01 “Recognition and Measurement of Financial Assets and Financial Liabilities”. ASU 2016-01 revises the accounting for the classification and measurement of investments in equity securities and revises the presentation of certain fair value changes for financial liabilities measured at fair value. For equity securities, the guidance in ASU 2016-01 requires equity investments to be measured at fair value with changes in fair value recognized in net income. For financial liabilities that are measured at fair value in accordance with the fair value option, the guidance requires presenting in other comprehensive income the change in fair value that relates to a change in instrument-specific credit risk. ASU 2016-01 also eliminates the disclosure assumptions used to estimate fair value for financial instruments measured at amortized cost and requires disclosure of an exit price notion in determining the fair value of financial instruments measured at amortized cost. ASU 2016-01 is effective for interim and annual periods beginning after December 15, 2017. The Corporation is currently evaluating the impact ASU 2016-01 will have on its financial statements.

2. Issuance of Common Stock

On June 10, 2015, the Corporation sold 350,000 shares of common stock, par value \$1.25 per share, in a private offering to accredited individual and institutional investors at \$23.50 per share. The Corporation realized \$8.2 million in proceeds from the offering, net of \$63,000 of direct costs relating to the offering.

3. Participation in the Small Business Lending Fund (SBLF) of the U.S. Treasury Department (U.S. Treasury)

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$10.0 million, pursuant to the U.S. Treasury’s SBLF program. On

September 17, 2013, with the approval of the Corporation's primary federal banking regulator, the Corporation redeemed 5,000 shares, or 50%, of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of \$5.0 million, plus accrued but unpaid dividends. On September 30, 2015, the Corporation redeemed the remaining 5,000 shares of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of \$5.0 million, plus accrued but unpaid dividends. Following this redemption, the Corporation does not have any Series B Preferred Stock outstanding.

F-15

## Notes to Consolidated Financial Statements (continued)

## 4. Securities

The following table summarizes the Corporation's securities as of December 31:

<i>(Dollar amounts in thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale:				
December 31, 2015:				
U.S. Treasury and federal agency	\$ 1,493	\$ -	\$ (27)	) \$ 1,466
U.S. government sponsored entities and agencies	8,998	2	(47)	) 8,953
U.S. agency mortgage-backed securities: residential	32,947	256	(53)	) 33,150
U.S. agency collateralized mortgage obligations: residential	32,289	23	(872)	) 31,440
State and political subdivision	28,352	264	(25)	) 28,591
Corporate debt securities	7,507	1	(21)	) 7,487
Equity securities	1,769	188	(63)	) 1,894
	\$ 113,355	\$ 734	\$ (1,108)	) \$ 112,981
December 31, 2014:				
U.S. Treasury and federal agency	\$ 1,491	\$ -	\$ (35)	) \$ 1,456
U.S. government sponsored entities and agencies	35,452	10	(238)	) 35,224
U.S. agency mortgage-backed securities: residential	38,026	745	-	) 38,771
U.S. agency collateralized mortgage obligations: residential	37,564	16	(963)	) 36,617
State and political subdivision	32,665	550	(191)	) 33,024
Corporate debt securities	2,006	-	(8)	) 1,998
Equity securities	2,356	415	-	) 2,771
	\$ 149,560	\$ 1,736	\$ (1,435)	) \$ 149,861

Securities with carrying values of \$75.0 million and \$91.4 million as of December 31, 2015 and 2014, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

Gains on sales of available for sale securities for the years ended December 31 were as follows:

<i>(Dollar amounts in thousands)</i>	2015	2014
Proceeds	\$ 36,314	\$ 24,452
Gains	876	850



Losses	(22 )	(92 )
Tax provision related to gains	290	258

F-16

## Notes to Consolidated Financial Statements (continued)

## 4. Securities (continued)

The following table summarizes scheduled maturities of the Corporation's debt securities as of December 31, 2015. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

<i>(Dollar amounts in thousands)</i>	Available for sale	
	Amortized Cost	Fair Value
Due in one year or less	\$1,210	\$1,222
Due after one year through five years	20,954	20,923
Due after five through ten years	23,447	23,610
Due after ten years	739	742
U.S. agency mortgage-backed securities: residential	32,947	33,150
U.S. agency collateralized mortgage obligations: residential	32,289	31,440
	\$111,586	\$111,087

Information pertaining to securities with gross unrealized losses at December 31, 2015 and 2014 aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

<i>(Dollar amounts in thousands)</i>	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Description of Securities						
December 31, 2015:						
U.S. Treasury and federal agency	\$ -	\$ -	\$1,466	\$ (27 )	\$1,466	\$ (27 )
U.S. government sponsored entities and agencies	4,962	(36 )	1,989	(11 )	6,951	(47 )
U.S. agency mortgage-backed securities: residential	6,710	(53 )	-	-	6,710	(53 )
U.S. agency collateralized mortgage obligations: residential	4,283	(41 )	25,336	(831 )	29,619	(872 )
State and political subdivision	1,028	(2 )	1,819	(23 )	2,847	(25 )
Corporate debt securities	3,484	(20 )	500	(1 )	3,984	(21 )
Equity securities	1,137	(63 )	-	-	1,137	(63 )
	\$21,604	\$ (215 )	\$31,110	\$ (893 )	\$52,714	\$ (1,108 )

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

December 31, 2014:

U.S. Treasury and federal agency	\$ -	\$ -	\$ 1,456	\$ (35 )	\$ 1,456	\$ (35 )
U.S. government sponsored entities and agencies	11,412	(51 )	16,805	(187 )	28,217	(238 )
U.S. agency collateralized mortgage obligations: residential	2,715	(14 )	30,594	(949 )	33,309	(963 )
State and political subdivision	5,154	(22 )	10,221	(169 )	15,375	(191 )
Corporate debt securities	1,998	(8 )	-	-	1,998	(8 )
	\$ 21,279	\$ (95 )	\$ 59,076	\$ (1,340 )	\$ 80,355	\$ (1,435 )

F-17

**Notes to Consolidated Financial Statements (continued)****4. 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 security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Corporation intends to sell an impaired security, or if it is more likely than not the Corporation will be required to sell the security before its anticipated recovery, the Corporation records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost. Otherwise, only the credit portion of the estimated loss on debt securities is recognized in earnings, with the other portion of the loss recognized in other comprehensive income. For equity securities determined to be other-than-temporarily impaired, the entire amount of impairment is recognized through earnings.

There were two equity securities in an unrealized loss position for less than 12 months as of December 31, 2015. Equity securities owned by the Corporation consist of common stock of various financial service providers. These investment securities are in unrealized loss positions as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability, capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the equity securities with unrealized losses as of December 31, 2015 to be other-than-temporarily impaired.

There were 57 debt securities in an unrealized loss position as of December 31, 2015, of which 35 were in an unrealized loss position for more than 12 months. Of these 35 securities, 22 were collateralized mortgage obligations (issued by U.S. government sponsored entities), 9 were state and political subdivisions securities, 2 were U.S. Treasury securities, 1 was a U.S. government sponsored entities and agencies security and 1 was a corporate security. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that is likely to result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of December 31, 2015 to be other-than-temporarily impaired.

F-18

**Notes to Consolidated Financial Statements (continued)****5. Loans Receivable and Related Allowance for Loan Losses**

The following table summarizes the Corporation's loans receivable as of December 31:

(Dollar amounts in thousands)	2015	2014
Mortgage loans on real estate:		
Residential first mortgages	\$ 139,305	\$ 107,173
Home equity loans and lines of credit	87,410	89,106
Commercial real estate	129,691	110,810
	356,406	307,089
Other loans:		
Commercial business	71,948	70,185
Consumer	6,742	7,598
	78,690	77,783
Total loans, gross	435,096	384,872
Less allowance for loan losses	5,205	5,224
Total loans, net	\$429,891	\$379,648

During 2015, the Corporation purchased four syndicated national credits (SNCs) each having a principal amount of \$1.0 million. The SNCs were purchased for a total of \$4.0 million plus a net premium of \$21,000 which is being amortized over the lives of the loans. During 2014, the Corporation purchased four SNCs each having a principal amount of \$1.0 million. The SNCs were purchased for a total of \$4.0 million plus a net premium of \$15,000 and other costs totaling \$11,000 which are being amortized over the lives of the loans. The SNCs are recorded as commercial business loans and are collateralized by all business assets of the individual borrowers. Until sufficient historical performance data can be collected and analyzed, these credits are assigned allowance for loan losses equal to a multiple of the Corporation's normal allowance allocation for Bank originated commercial business loans. As of December 31, 2015, these SNC's had a remaining outstanding balance of \$5.8 million.

During 2015, the Corporation also purchased two pools of residential mortgage loans totaling \$19.2 million.

## Notes to Consolidated Financial Statements (continued)

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

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

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the year ended		Cash Basis Interest Recognized in Period
	As of December 31, 2015			December 31, 2015		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized in Period	
Residential first mortgages	\$169	\$ 169	\$ 29	\$170	\$ 6	\$ 6
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	93	93	5	1,613	12	9
Commercial business	923	923	76	1,641	112	99
Consumer	-	-	-	-	-	-
Total	\$1,185	\$ 1,185	\$ 110	\$3,424	\$ 130	\$ 114

	Impaired Loans with No Specific Allowance			For the year ended		Cash Basis Interest Recognized in Period
	As of December 31, 2015			December 31, 2015		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized in Period	
Residential first mortgages	\$-	\$ -	\$45	\$ 7	\$ 7	
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	1,145	746	1,069	49	40	
Commercial business	76	76	66	3	3	
Consumer	-	-	-	-	-	-
Total	\$1,221	\$ 822	\$1,180	\$ 59	\$ 50	

Impaired Loans with Specific Allowance

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

	As of December 31, 2014			For the year ended December 31, 2014		Cash Basis
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Interest Recognized in Period
Residential first mortgages	\$171	\$ 171	\$ 27	\$136	\$ 12	\$ 12
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,615	2,674	268	2,673	16	-
Commercial business	2,622	2,622	495	1,524	66	-
Consumer	-	-	-	-	-	-
Total	\$6,408	\$ 5,467	\$ 790	\$4,333	\$ 94	\$ 12

	Impaired Loans with No Specific Allowance			For the year ended December 31, 2014		Cash Basis
	As of December 31, 2014	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Interest Recognized in Period
Residential first mortgages	\$114	\$ 114	\$74	\$ 2	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	1,254	855	839	15	4	4
Commercial business	51	51	250	1	1	1
Consumer	-	-	1,078	533	533	533
Total	\$1,419	\$ 1,020	\$2,241	\$ 551	\$ 538	\$ 538



**Notes to Consolidated Financial Statements (continued)**

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

Unpaid principal balance includes any loans that have been partially charged off but not forgiven. Accrued interest is not included in the recorded investment in loans 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 has no legal obligation to extend additional credit to borrowers with loans classified as TDRs.

At December 31, 2015 and 2014, the Corporation had \$835,000 and \$5.6 million, respectively, of loans classified as TDRs, which are included in impaired loans above. At December 31, 2015 and 2014, the Corporation had \$63,000 and \$513,000, respectively, of the allowance for loan losses allocated to these specific loans.

During the year ended December 31, 2015, the Corporation did not modify any loans as TDRs.

During the year ended December 31, 2014, the Corporation modified ten loans to be identified as TDRs. One commercial relationship consisting of seven loans with pre- and post-modification recorded investments of \$2.4 million was modified as the Corporation granted repayment concessions due to financial difficulties experienced by the borrower. Concessions on these seven loans included reduced monthly payments through the notes' maturities. At December 31, 2014, the Corporation had \$285,000 of the allowance for loan losses allocated to this specific relationship. These loans were repaid during 2015.

Also during 2014, an additional relationship consisting of two commercial real estate loans with pre- and post-modification recorded investments of \$2.1 million was modified as the Corporation granted a payment concession on one loan and interest rate concessions on both loans due to cash flow considerations caused by vacancy rates. These loans were previously impaired with specific reserves allocated to them. At December 31, 2014 the Corporation had \$126,000 of the allowance for loan losses allocated to this specific relationship. These loans were repaid during 2015.

In addition, the Corporation modified a residential mortgage loan with pre- and post-modification recorded investments of \$76,000 and \$93,000, respectively, due to a bankruptcy court order. The modifications included capitalization of \$5,000 of accrued and unpaid interest and \$13,000 of legal expenses, a reduction in the interest rate from 6.25% to 5.00% and a 15 year extension of the original term. At December 31, 2015 and 2014, the Corporation had allowance for loan losses allocated to this specific loan of \$10,000 and \$7,000, respectively.

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms. During year ended December 31, 2015, there was a default on one \$91,000 residential mortgage loan within 12 months following modification classified as a TDR. At December 31, 2015, this loan was over 90 days past due. This default had no impact on the provision for loan losses for the year ended December 31, 2015. During the year ended December 31, 2014, there were no loans classified as TDRs which defaulted within twelve months of their modification.

**Notes to Consolidated Financial Statements (continued)**

**5. 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 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. These homogeneous loans are not rated unless identified as impaired.

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 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.

F-22

## Notes to Consolidated Financial Statements (continued)

## 5. 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 December 31, 2015 and 2014:

<i>(Dollar amounts in thousands)</i>	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2015:						
Residential first mortgages	\$ 138,096	\$-	\$ -	\$ 1,209	\$ -	\$ 139,305
Home equity and lines of credit	87,015	-	-	395	-	87,410
Commercial real estate	-	125,539	88	4,064	-	129,691
Commercial business	-	69,740	942	1,266	-	71,948
Consumer	6,742	-	-	-	-	6,742
Total	\$ 231,853	\$ 195,279	\$ 1,030	\$ 6,934	\$ -	\$ 435,096
December 31, 2014:						
Residential first mortgages	\$ 106,448	\$-	\$ -	\$ 725	\$ -	\$ 107,173
Home equity and lines of credit	88,699	-	-	407	-	89,106
Commercial real estate	-	103,908	515	6,387	-	110,810
Commercial business	-	65,627	1,292	3,266	-	70,185
Consumer	7,598	-	-	-	-	7,598
Total	\$ 202,745	\$ 169,535	\$ 1,807	\$ 10,785	\$ -	\$ 384,872

Accrued interest is not included in the recorded investment in loans based on the amounts not being material.

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 required payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of December 31, 2015 and 2014:

Performing Accruing	Accruing 30-59 Days	Accruing 60-89 Days	Nonperforming Accruing	Total
------------------------	------------------------	------------------------	---------------------------	-------

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

	Loans Not			90 Days +	Past Due	Nonaccrual	Loans
<i>(Dollar amounts in thousands)</i>	Past Due	Past Due	Past Due	Past Due			
December 31, 2015:							
Residential first mortgages	\$ 136,924	\$ 1,097	\$ 75	\$ -	\$ 1,209	\$ 139,305	
Home equity and lines of credit	86,691	308	16	-	395	87,410	
Commercial real estate	128,945	-	-	-	746	129,691	
Commercial business	71,229	-	-	-	719	71,948	
Consumer	6,723	19	-	-	-	6,742	
Total loans	\$ 430,512	\$ 1,424	\$ 91	\$ -	\$ 3,069	\$ 435,096	
December 31, 2014:							
Residential first mortgages	\$ 104,523	\$ 1,523	\$ 402	\$ 78	\$ 647	\$ 107,173	
Home equity and lines of credit	87,982	675	42	-	407	89,106	
Commercial real estate	107,292	30	55	16	3,417	110,810	
Commercial business	67,808	-	-	-	2,377	70,185	
Consumer	7,545	41	12	-	-	7,598	
Total loans	\$ 375,150	\$ 2,269	\$ 511	\$ 94	\$ 6,848	\$ 384,872	

F-23

**Notes to Consolidated Financial Statements (continued)****5. Loans Receivable and Related Allowance for Loan Losses (continued)**

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

<i>(Dollar amounts in thousands)</i>	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total Loans
December 31, 2015:					
Residential first mortgages	\$ 75	\$ -	\$ 79	\$ 1,055	\$1,209
Home equity and lines of credit	14	-	-	381	395
Commercial real estate	623	-	-	123	746
Commercial business	690	-	-	29	719
Consumer	-	-	-	-	-
Total loans	\$ 1,402	\$ -	\$ 79	\$ 1,588	\$3,069
December 31, 2014:					
Residential first mortgages	\$ 283	\$ -	\$ 80	\$ 284	\$647
Home equity and lines of credit	33	18	-	356	407
Commercial real estate	2,848	-	-	569	3,417
Commercial business	2,151	-	188	38	2,377
Consumer	-	-	-	-	-
Total loans	\$ 5,315	\$ 18	\$ 268	\$ 1,247	\$6,848

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

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.

Following is an analysis of the changes in the ALL for the years ended December 31:

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

(Dollar amounts in thousands)	2015	2014
Balance at the beginning of the year	\$5,224	\$4,869
Provision for loan losses	381	670
Charge-offs	(567 )	(364 )
Recoveries	167	49
Balance at the end of the year	\$5,205	\$5,224

F-24



## Notes to Consolidated Financial Statements (continued)

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

The following table details activity in the ALL and the recorded investment by portfolio segment based on impairment method at December 31, 2015 and 2014:

<i>(Dollar amounts in thousands)</i>	Residential Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
December 31, 2015:						
Beginning Balance	\$ 955	\$ 543	\$ 2,338	\$ 1,336	\$ 52	\$ 5,224
Charge-offs	(79 )	(221 )	(35 )	(182 )	(50 )	(567 )
Recoveries	-	30	88	31	18	167
Provision	553	234	(206 )	(225 )	25	381
Ending Balance	\$ 1,429	\$ 586	\$ 2,185	\$ 960	\$ 45	\$ 5,205
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	29	-	5	76	-	110
Collectively evaluated for impairment	1,400	586	2,180	884	45	5,095
Total loans:						
Individually evaluated for impairment	169	-	839	999	-	2,007
Collectively evaluated for impairment	139,136	87,410	128,852	70,949	6,742	433,089
December 31, 2014:						
Beginning Balance	\$ 923	\$ 625	\$ 2,450	\$ 822	\$ 49	\$ 4,869
Charge-offs	(134 )	(72 )	(2 )	(17 )	(139 )	(364 )
Recoveries	-	1	18	7	23	49
Provision	166	(11 )	(128 )	524	119	670
Ending Balance	\$ 955	\$ 543	\$ 2,338	\$ 1,336	\$ 52	\$ 5,224
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	27	-	268	495	-	790
Collectively evaluated for impairment	928	543	2,070	841	52	4,434
Total loans:						
Individually evaluated for impairment	285	-	3,529	2,673	-	6,487
Collectively evaluated for impairment	106,888	89,106	107,281	67,512	7,598	378,385

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.

**6. Federal Bank Stocks**

The Bank is a member of the FHLB and the FRB. As a member of these federal banking systems, the Bank maintains an investment in the capital stock of the respective regional banks, which are carried at cost. These stocks are purchased and redeemed at par as directed by the federal banks and levels maintained are based primarily on borrowing and other correspondent relationships. The Bank's investment in FHLB and FRB stocks was \$3.2 million and \$1.0 million, respectively, at December 31, 2015, and \$1.4 million and \$1.0 million, respectively, at December 31, 2014. The increase in FHLB capital stock was the result of increased borrowing activity during 2015.

F-25

**Notes to Consolidated Financial Statements (continued)****7. Premises and Equipment**

Premises and equipment at December 31 are summarized by major classification as follows:

(Dollar amounts in thousands)	2015	2014
Land	\$3,719	\$3,416
Buildings and improvements	11,446	10,833
Leasehold improvements	1,224	1,105
Furniture, fixtures and equipment	7,576	6,851
Software	3,206	2,979
Construction in progress	1,692	1,670
	28,863	26,854
Less: accumulated depreciation and amortization	12,749	11,710
	\$16,114	\$15,144

Depreciation and amortization expense for the years ended December 31, 2015 and 2014 were \$1.0 million and \$871,000, respectively.

Rent expense under non-cancelable operating lease agreements for the years ended December 31, 2015 and 2014 was \$226,000 and \$241,000, respectively. Rent commitments under non-cancelable operating lease agreements for certain branch offices for the years ended December 31, are as follows, before considering renewal options that are generally present:

(Dollar amounts in thousands)	Amount
2016	\$ 259
2017	229
2018	167
2019	167
2020	151
Thereafter	636
	\$ 1,609

**8. Goodwill and Intangible Assets**

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

The following table summarizes the Corporation's acquired goodwill and intangible assets as of December 31:

(Dollar amounts in thousands)	2015		2014	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$3,664	\$ -	\$3,664	\$ -
Core deposit intangibles	4,027	3,473	4,027	3,278
Total	\$7,691	\$ 3,473	\$7,691	\$ 3,278

F-26

**Notes to Consolidated Financial Statements (continued)****8. Goodwill and Intangible Assets (continued)**

Goodwill resulted from three previous branch acquisitions. Goodwill represents the excess of the total purchase price paid for the branch acquisitions over the fair value of the assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The Corporation has selected November 30 as the date to perform the annual impairment test. Impairment exists when a reporting unit's carrying amount exceeds its fair value. At November 30, 2015, the Corporation elected to perform a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeded its carrying amount, including goodwill. The qualitative assessment indicated that it was more likely than not that the fair value of the reporting unit exceeded its carrying value, resulting in no impairment. No goodwill impairment charges were recorded in 2015 or 2014. Goodwill is the only intangible asset with an indefinite life on the Corporation's balance sheet.

Also, in connection with the assumption of deposits related to the 2009 Titusville branch acquisition, the Bank recorded a core deposit intangible of \$2.8 million during 2009. This intangible asset amortizes 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. The Corporation recorded intangible amortization expense totaling \$195,000 and \$216,000 in 2015 and 2014, respectively.

The estimated amortization expense of the core deposit intangible for the years ending December 31, are as follows:

	Amortization
<i>(Dollar amounts in thousands)</i>	Expense
2016	\$ 195
2017	195
2018	164
2019	-
2020	-
	\$ 554

**9. Related Party Balances and Transactions**

In the ordinary course of business, the Bank maintains loan and deposit relationships with employees, principal officers and directors. The Bank has granted loans to principal officers and directors and their affiliates amounting to \$2.2 million and \$2.1 million at December 31, 2015 and 2014, respectively. During 2015, total principal additions and

total principal reductions associated with these loans were \$486,000 and \$321,000, respectively. Deposits from principal officers and directors held by the Bank at December 31, 2015 and 2014 totaled \$4.0 million and \$5.0 million, respectively.

In addition, directors and their affiliates may provide certain professional and other services to the Corporation and the Bank in the ordinary course of business. During 2015, the Corporation did not pay affiliates for any such services. During 2014, amounts paid to affiliates for such services totaled \$247,000.

F-27

**Notes to Consolidated Financial Statements (continued)****10. Deposits**

The following table summarizes the Corporation's deposits as of December 31:

(Dollar amounts in thousands)	2015			2014		
Type of accounts	Weighted average rate	Amount	%	Weighted average rate	Amount	%
Non-interest bearing deposits	-	\$119,790	24.4 %	-	\$111,282	22.2 %
Interest bearing demand deposits	0.15 %	256,620	52.4 %	0.15 %	269,402	53.7 %
Time deposits	1.46 %	113,477	23.2 %	1.52 %	121,135	24.1 %
	0.42 %	\$489,887	100.0 %	0.45 %	\$501,819	100.0 %

Scheduled maturities of time deposits for the next five years are as follows:

(Dollar amounts in thousands)	Amount	%
2016	\$31,903	28.1 %
2017	14,173	12.5 %
2018	25,973	22.9 %
2019	25,004	22.0 %
2020	10,139	8.9 %
Thereafter	6,285	5.6 %
	\$113,477	100.0 %

The Corporation had a total of \$22.2 million and \$28.0 million in time deposits of \$250,000 or more at December 31, 2015 and 2014, respectively. Scheduled maturities of time deposits of \$250,000 or more at December 31, 2015 are as follows:

(Dollar amounts in thousands)	Amount
Three months or less	\$2,773
Over three months to six months	1,101
Over six months to twelve months	6,366

Over twelve months	11,999
	\$22,239

F-28



**Notes to Consolidated Financial Statements (continued)****11. Borrowed Funds**

The following table summarizes the Corporation's borrowed funds as of and for the year ended December 31:

(Dollar amounts in thousands)	2015			2014		
	Balance	Average Balance	Average Rate	Balance	Average Balance	Average Rate
Due within 12 months	\$14,250	\$6,284	1.38 %	\$6,500	\$3,581	2.72 %
Due beyond 12 months but within 5 years	35,000	15,205	3.97 %	15,000	15,836	4.00 %
	\$49,250	\$21,489		\$21,500	\$19,417	

Short-term borrowed funds at December 31, 2015 consisted of \$14.3 million in FHLB overnight advances with a rate of 0.43%, compared to short-term borrowed funds of \$6.5 million at December 2014 which consisted of \$3.5 million in FHLB overnight advance with a rate of 0.27% and \$3.0 million outstanding on a line of credit with a correspondent bank with a rate of 4.25%.

Long-term borrowed funds at December 31, 2015 consisted of seven \$5.0 million FHLB term advances totaling \$35.0 million, compared to three \$5.0 million FHLB advances totaling \$15.0 million at December 31, 2014. All borrowings from the FHLB are secured by a blanket lien of qualified collateral. Qualified collateral at December 31, 2015 totaled \$219.8 million.

During the fourth quarter of 2015, the Corporation borrowed four \$5.0 million FHLB term advances. Two of the advances have three year terms and fixed rates of 1.69% and 1.62%, respectively. The third and fourth advances have four and five year terms, respectively, and fixed rates of 1.94% and 2.06%, respectively.

The three remaining \$5.0 million FHLB term advances each have a fixed rate of 0.93% and mature in November 2017. These three advances originally had rates of 4.98%, 4.83% and 4.68%, but were exchanged and modified in 2012 for advances with a rate of 0.93%. At the time of the exchange, prepayment penalties associated with the three advances totaled \$2.3 million and were cash-settled with the FHLB at the time of modification. The Corporation is amortizing this prepayment penalty over the life of the new advances. At December 31, 2015, unamortized prepayment penalties totaled \$872,000.

Before modification, the three advances totaling \$15.0 million had a weighted average rate of 4.83%. After modification and including prepayment penalty amortization, the three advances have a weighted average rate of 3.98%.

F-29

**Notes to Consolidated Financial Statements (continued)****11. Borrowed Funds (continued)**

Scheduled maturities of borrowed funds for the next five years are as follows:

(Dollar amounts in thousands)	Amount
2016	\$ 14,250
2017	15,000
2018	10,000
2019	5,000
2020	5,000
Thereafter	-
	\$49,250

The Bank maintains a credit arrangement with the FHLB as a source of additional liquidity. The total maximum borrowing capacity with the FHLB, excluding loans outstanding of \$49.3 million and irrevocable standby letters of credit issued to secure certain deposit accounts of \$50.0 million at December 31, 2015 was \$120.6 million. In addition, the Corporation has \$7.5 million of funds available on a line of credit through another correspondent bank.

**12.****Regulatory Matters***Restrictions on Dividends, Loans and Advances*

The Bank is subject to a regulatory dividend restriction that generally limits the amount of dividends that can be paid by the Bank to the Corporation. Prior regulatory approval is required if the total of all dividends declared in any calendar year exceeds net profits (as defined in the regulations) for the year combined with net retained earnings (as defined) for the two preceding calendar years. In addition, dividends paid by the Bank to the Corporation would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. As of December 31, 2015, \$3.4 million of undistributed earnings of the Bank was available for distribution of dividends without prior regulatory approval.

Loans or advances from the Bank to the Corporation are limited to 10% of the Bank's capital stock and surplus on a secured basis. Funds available for loans or advances by the Bank to the Corporation amounted to approximately \$3.5

million. The Corporation has a \$2.2 million commercial line of credit available at the Bank for the primary purpose of purchasing qualified equity investments. At December 31, 2015, the Corporation had an outstanding balance on this line of \$1.0 million.

### ***Minimum Regulatory Capital Requirements***

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

F-30

**Notes to Consolidated Financial Statements (continued)****12. Regulatory Matters (continued)**

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (BASEL III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019.

Quantitative measures established by the regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 capital and common equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined).

In 2015, the Board of Governors of the Federal Reserve System amended its Small Bank Holding Company Policy Statement by increasing the policy's consolidated assets threshold from \$500 million to \$1 billion. The primary benefit of being deemed a "small bank holding company" is the exemption from the requirement to maintain consolidated regulatory capital ratios; instead, regulatory capital ratios only apply at the subsidiary bank level. In addition, the Bank in its March 31, 2015 quarterly filing made a one-time permanent election to continue to exclude accumulated other comprehensive income from capital.

As of December 31, 2015, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category.

The following table sets forth certain information concerning the Bank's regulatory capital as of the dates presented:

(Dollar amounts in thousands)	December 31, 2015		December 31, 2014	
	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets:				
Actual	\$ 56,090	13.99 %	\$ 52,329	14.84 %
For capital adequacy purposes	32,070	8.00 %	28,201	8.00 %
To be well capitalized	40,087	10.00 %	35,251	10.00 %

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Tier 1 capital to risk-weighted assets:					
Actual	\$ 51,073	12.74	%	\$ 47,878	13.58 %
For capital adequacy purposes	24,052	6.00	%	14,101	4.00 %
To be well capitalized	32,070	8.00	%	21,151	6.00 %
Common Equity Tier 1 capital to risk-weighted assets:					
Actual	\$ 51,073	12.74	%	N/A	N/A
For capital adequacy purposes	18,039	4.50	%	N/A	N/A
To be well capitalized	26,057	6.50	%	N/A	N/A
Tier 1 capital to average assets:					
Actual	\$ 51,073	8.83	%	\$ 47,878	8.25 %
For capital adequacy purposes	23,131	4.00	%	23,222	4.00 %
To be well capitalized	28,914	5.00	%	29,028	5.00 %

F-31

**Notes to Consolidated Financial Statements (continued)****13. Commitments and Legal Contingencies**

In the ordinary course of business, the Corporation has various outstanding commitments and contingent liabilities that are not reflected in the accompanying consolidated financial statements. In addition, the Corporation is involved in certain claims and legal actions arising in the ordinary course of business. The outcome of these claims and actions are not presently determinable; however, in the opinion of the Corporation's management, after consulting legal counsel, the ultimate disposition of these matters will not have a material adverse effect on the consolidated financial statements.

**14.****Income Taxes**

The Corporation and the Bank file a consolidated federal income tax return. The provision for income taxes for the years ended December 31 is comprised of the following:

(Dollar amounts in thousands)	2015	2014
Current	\$(5 )	\$1,023
Deferred	1,146	25
	\$1,141	\$1,048

A reconciliation between the provision for income taxes and the amount computed by multiplying operating results before income taxes by the statutory federal income tax rate of 34% for the years ended December 31 is as follows:

(Dollar amounts in thousands)	2015			2014		
	Amount	% Pre-tax Income	%	Amount	% Pre-tax Income	%
Provision at statutory tax rate	\$1,800	34.0	%	\$1,722	34.0	%
Increase (decrease) resulting from:						
Tax free interest, net of disallowance	(542 )	(10.2	)%	(580 )	(11.4	)%
Earnings on bank-owned life insurance	(112 )	(2.1	)%	(111 )	(2.2	)%
Other, net	(5 )	(0.1	)%	17	0.3	%
Provision	\$1,141	21.6	%	\$1,048	20.7	%

**Notes to Consolidated Financial Statements (continued)****14. Income Taxes (continued)**

The tax effects of temporary differences between the financial reporting basis and income tax basis of assets and liabilities that are included in the net deferred tax asset as of December 31 relate to the following:

(Dollar amounts in thousands)	2015	2014
Deferred tax assets:		
Funded status of pension plan	\$1,810	\$1,646
Allowance for loan losses	1,805	1,735
Deferred compensation	406	358
Accrued incentive compensation	220	141
Stock compensation	155	166
Securities impairment	149	149
Net unrealized loss on securities	127	-
Nonaccrual loan interest income	68	153
Other	52	8
Gross deferred tax assets	4,792	4,356
Deferred tax liabilities:		
	-	-
Accrued pension liability	1,702	657
Depreciation	908	765
Intangible assets	317	307
Deferred loan fees	284	149
Net unrealized gains on securities	-	102
Other	30	72
Gross deferred tax liabilities	3,241	2,052
Net deferred tax asset	\$1,551	\$2,304

In accordance with relevant accounting guidance, the Corporation determined that it was not required to establish a valuation allowance for deferred tax assets since it is more likely than not that the deferred tax asset will be realized through carry-back to taxable income in prior years, future reversals of existing taxable temporary differences, tax strategies and, to a lesser extent, future taxable income. The Corporation's net deferred tax asset or liability is recorded in the consolidated financial statements as a component of other assets or other liabilities.



At December 31, 2015 and December 31, 2014, the Corporation had no unrecognized tax benefits. The Corporation does not expect the total amount of unrecognized tax benefits to significantly increase within the next twelve months. The Corporation recognizes interest and penalties on unrecognized tax benefits in income taxes expense in its Consolidated Statements of Income.

The Corporation and the Bank are subject to U.S. federal income tax as well as a capital-based franchise tax in the Commonwealth of Pennsylvania. The Corporation and the Bank are no longer subject to examination by taxing authorities for years before 2012.

F-33

**Notes to Consolidated Financial Statements (continued)****15. Employee Benefit Plans***Defined Benefit Plan*

The Corporation provides pension benefits for eligible employees through a defined benefit pension plan. Substantially all employees participate in the retirement plan on a non-contributing basis, and are fully vested after three years of service. Effective January 1, 2009, the plan was closed to new participants. The Corporation provided the requisite notice to plan participants on March 12, 2013 of the determination to freeze the plan (curtailment). While the freeze was not effective until April 30, 2013, management determined that participants would not satisfy, within the provisions of the plan, 2013 eligibility requirements based on minimum hours worked for 2013. Therefore, employees ceased to earn benefits as of January 1, 2013. This amendment to the plan will not affect benefits earned by the participant prior to the date of the freeze. The Corporation measures the funded status of the plan as of December 31.

Information pertaining to changes in obligations and funded status of the defined benefit pension plan for the years ended December 31 is as follows:

(Dollar amounts in thousands)	2015	2014
Change in plan assets:		
Fair value of plan assets at beginning of year	\$6,851	\$6,386
Actual return on plan assets	(120 )	309
Employer contribution	3,000	500
Benefits paid	(363 )	(344 )
Fair value of plan assets at end of year	9,368	6,851
Change in benefit obligation:		
Benefit obligation at beginning of year	10,249	7,643
Service cost	-	-
Interest cost	403	380
Actuarial loss	254	355
Effect of change in assumptions	(369 )	2,215
Benefits paid	(363 )	(344 )
Benefit obligation at end of year	10,174	10,249
Funded status (plan assets less benefit obligation)	\$(806 )	\$(3,398 )

Amounts recognized in accumulated other comprehensive loss, net of tax, consists of:

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Accumulated net actuarial loss	\$3,529	\$3,232
Accumulated prior service benefit	(15 )	(36 )
Amount recognized, end of year	\$3,514	\$3,196

F-34

## Notes to Consolidated Financial Statements (continued)

## 15. Employee Benefit Plans (continued)

The following table presents the Corporation's pension plan assets measured and recorded at estimated fair value on a recurring basis and their level within the estimated fair value hierarchy as described in Note 17:

Description	Total	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
December 31, 2015:				
Money markets	\$757	\$ 757	\$ -	\$ -
Mutual funds - debt	4,127	-	4,127	-
Mutual funds - equity	3,812	-	3,812	-
Emclaire stock	672	672	-	-
	\$9,368	\$ 1,429	\$ 7,939	\$ -
December 31, 2014:				
Money markets	\$565	\$ 565	\$ -	\$ -
Mutual funds - debt	3,313	-	3,313	-
Mutual funds - equity	2,273	-	2,273	-
Emclaire stock	700	700	-	-
	\$6,851	\$ 1,265	\$ 5,586	\$ -

There were no significant transfers between Level 1 and Level 2 during 2015.

The accumulated benefit obligation for the defined benefit pension plan was \$10.2 million and \$10.2 million at December 31, 2015 and 2014, respectively.

The components of the periodic pension costs and other amounts recognized in other comprehensive income for the years ended December 31 are as follows:

(Dollar amounts in thousands)	2015	2014
-------------------------------	------	------

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Interest cost	\$403	\$380
Expected return on plan assets	(652)	(502 )
Amortization of prior service benefit and net loss	174	58
Net periodic pension benefit	(75 )	(64 )
Amortization of prior service benefit and net loss	(174)	(58 )
Net loss	657	2,764
Total recognized in other comprehensive loss	483	2,706
Total recognized in net periodic benefit and other comprehensive loss	\$408	\$2,642

The estimated net loss and prior service benefit for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$193,000 as of December 31, 2015.

F-35

**Notes to Consolidated Financial Statements (continued)****15. Employee Benefit Plans (continued)**

Weighted-average actuarial assumptions for the years ended December 31 include the following:

	2015	2014
Discount rate for net periodic benefit cost	3.91%	4.86%
Discount rate for benefit obligations	4.41%	3.91%
Expected rate of return on plan assets	7.75%	7.75%

The Corporation's pension plan asset allocation at December 31, 2015 and 2014, target allocation for 2016, and expected long-term rate of return by asset category are as follows:

Asset Category	Target Allocation		Percentage of Plan Assets at Year End				Weighted-Average Expected Long-Term Rate of Return	
	2016		2015		2014		2015	
Equity securities	45	%	44	%	39	%	4.47	%
Debt securities	45	%	48	%	53	%	3.25	%
Money markets	10	%	8	%	8	%	0.03	%
	100	%	100	%	100	%	7.75	%

***Investment Strategy***

The intent of the pension plan is to provide a range of investment options for building a diversified asset allocation strategy that will provide the highest likelihood of meeting the aggregate actuarial projections. In selecting the options and asset allocation strategy, the Corporation has determined that the benefits of reduced portfolio risk are best achieved through diversification. The following asset classes or investment categories are utilized to meet the Pension plan's objectives: Small company stock, International stock, Mid-cap stock, Large company stock, Diversified bond, Money Market/Stable Value and Cash. The pension plan does not prohibit any certain investments.

The Corporation does currently not expect to make a contribution to its pension plan in 2016.

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

(Dollar amounts in thousands)	Pension
For year ended December 31,	Benefits
2016	\$354
2017	352
2018	345
2019	369
2020	395
2021-2025	2,261
Thereafter	6,098
Benefit Obligation	\$10,174

F-36

**Notes to Consolidated Financial Statements (continued)**

**15. Employee Benefit Plans (continued)**

***Defined Contribution Plan***

The Corporation maintains a defined contribution 401(k) Plan. Employees are eligible to participate by providing tax-deferred contributions up to 20% of qualified compensation. Employee contributions are vested at all times. The Corporation provides a matching contribution of up to 4% of the participant's salary. For the years ended 2015 and 2014, matching contributions were \$178,000 and \$171,000, respectively. The Corporation may also make, at the sole discretion of its Board of Directors, a profit sharing contribution. For the years ended 2015 and 2014, the Corporation made profit sharing contributions of \$108,000 and \$100,000, respectively.

***Supplemental Executive Retirement Plan***

The Corporation maintains a Supplemental Executive Retirement Plan (SERP) to provide certain additional retirement benefits to participating officers. The SERP is subject to certain vesting provisions and provides that the officers shall receive a supplemental retirement benefit if the officer's employment is terminated after reaching the normal retirement age of 65, with benefits also payable upon death, disability, a change of control or a termination of employment prior to normal retirement age. As of December 31, 2015 and 2014, the Corporation's SERP liability was \$1.1 million and \$974,000, respectively. For the years ended December 31, 2015 and 2014, the Corporation recognized expense of \$162,000 and \$150,000, respectively, related to the SERP.

**16. Stock Compensation Plans**

In April 2014, the Corporation adopted the 2014 Stock Incentive Plan (the 2014 Plan), which is shareholder approved and permits the grant of restricted stock awards and options to its directors, officers and employees for up to 176,866 shares of common stock, of which 75,483 shares of restricted stock and 88,433 stock options remain available for issuance under the plan.

In addition, the Corporation's 2007 Stock Incentive Plan and Trust (the 2007 Plan), which is shareholder approved, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock, of which 1,313 shares of restricted stock and 45,283 stock options remain available for



issuance under the plan.

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

During 2015 and 2014, the Corporation granted restricted stock awards of 9,650 and 9,250 shares, respectively, with a face value of \$227,000 and \$227,000, respectively, based on the weighted-average grant date stock prices of \$23.53 and \$24.50, respectively. These restricted stock awards are 100% vested on the third anniversary of the date of grant, except in the event of death, disability or retirement. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. There were no stock options granted during 2015 or 2014. For the year ended December 31, 2015 and 2014 the Corporation recognized \$184,000 and \$198,000, respectively, in stock compensation expense.

**Notes to Consolidated Financial Statements (continued)****16. Stock Compensation Plans (continued)**

A summary of the status of the Corporation's nonvested restricted stock awards as of December 31, 2015, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2015	25,450	\$ 23.03
Granted	9,650	23.53
Vested	(10,400)	20.25
Forfeited	(1,250 )	24.70
Nonvested as of December 31, 2015	23,450	\$ 24.38

A summary of option activity under the plan as of December 31, 2015, and changes during the period then ended is presented below:

	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Term (in years)
Outstanding as of January 1, 2015	76,750	\$ 25.16	\$ 54,720	2.7
Granted	-	-	-	-
Exercised	(3,750 )	14.41	-	-
Forfeited	-	-	-	-
Outstanding as of December 31, 2015	73,000	\$ 25.71	\$ 9,000	1.6
Exercisable as of December 31, 2015	73,000	\$ 25.71	\$ 9,000	1.6

As of December 31, 2015, there was \$390,000 of total unrecognized compensation expense related to nonvested share-based compensation arrangements granted under the plan. That expense is expected to be recognized over the next three years. Nonvested restricted stock is not included in common shares outstanding on the consolidated balance sheets.

**17. Fair Values of Financial Instruments**

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

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.

F-38

**Notes to Consolidated Financial Statements (continued)**

**17. Fair Values of Financial Instruments (continued)**

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

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

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

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

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

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

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

transactions involving comparable businesses and other market, financial and nonfinancial factors.

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

F-39

**Notes to Consolidated Financial Statements (continued)****17. Fair Values of Financial Instruments (continued)**

*Impaired loans* – At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of December 31, 2015, the fair value of impaired loans consists of loan balances totaling \$643,000, net of a valuation allowance of \$47,000, compared to loan balances of \$3.0 million, net of a valuation allowance of \$596,000 at December 31, 2014. Additional provision for loan losses of \$47,000 and \$562,000 was recorded during the years ended December 31, 2015 and 2014, respectively, for these loans.

*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 December 31, 2015, OREO measured at fair value less costs to sell had a net carrying amount of \$13,000, which consisted of the outstanding balance of \$22,000 less write-downs of \$9,000. As of December 31, 2014, the Corporation did not have any OREO measured at fair value.

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

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

F-40

## Notes to Consolidated Financial Statements (continued)

## 17. Fair Values of Financial Instruments (continued)

*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.

Estimates of the fair value of off-balance sheet items were not made because of the short-term nature of these arrangements and the credit standing of the counterparties. Also, unfunded loan commitments relate principally to variable rate commercial loans.

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) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
December 31, 2015:				
U.S. Treasury and federal agency	\$1,466	\$ 1,466	\$ -	\$ -
U.S. government sponsored entities and agencies	8,953	-	8,953	-
U.S. agency mortgage-backed securities: residential	33,150	-	33,150	-
U.S. agency collateralized mortgage obligations: residential	31,440	-	31,440	-
State and political subdivision	28,591	-	28,591	-
Corporate debt securities	7,487	-	7,487	-
Equity securities	1,894	1,820	-	74
	\$112,981	\$ 3,286	\$ 109,621	\$ 74
December 31, 2014:				
U.S. Treasury and federal agency	\$1,456	\$ 1,456	\$ -	\$ -
U.S. government sponsored entities and agencies	35,224	-	35,224	-
U.S. agency mortgage-backed securities: residential	38,771	-	38,771	-



Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

U.S. agency collateralized mortgage obligations: residential	36,617	-	36,617	-
State and political subdivision	33,024	-	33,024	-
Corporate debt securities	1,998	-	1,998	-
Equity securities	2,771	1,873	-	898
	\$ 149,861	\$ 3,329	\$ 145,634	\$ 898

F-41

**Notes to Consolidated Financial Statements (continued)****17. Fair Values of Financial Instruments (continued)**

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During 2015 and 2014, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the years ended December 31, 2015 and 2014:

(Dollar amounts in thousands)	2015	2014
Balance at the beginning of the period	\$898	\$653
Total gains or losses (realized/unrealized):	-	-
Included in earnings	(298)	-
Included in other comprehensive income	61	245
Issuances	-	-
Sales	(587)	-
Transfers in and/or out of Level 3	-	-
Balance at the end of the period	\$74	\$898

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

(Dollar amounts in thousands)		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
December 31, 2015:				
Impaired commercial business loans	\$596	\$ -	\$ -	\$ 596
Other residential real estate owned	13	-	-	13
	\$609	\$ -	\$ -	\$ 609
December 31, 2014:				
Impaired commercial real estate loans	\$495	\$ -	\$ -	\$ 495
Impaired commercial business loans	1,865	-	-	1,865
	\$2,360	\$ -	\$ -	\$ 2,360

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

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

<i>(Dollar amounts in thousands)</i>		Valuation Techniques(s)	Unobservable Input (s)	Range
December 31, 2015:				
Impaired commercial business loans	\$596	Liquidation value of business assets	Adjustment for differences between comparable business assets	65%
Other residential real estate owned	13	Sales comparison approach	Adjustment for differences between comparable sales	10%
December 31, 2014:				
Impaired commercial real estate loans	\$495	Sales comparison approach/Contractual provision of USDA loan	Adjustment for differences between comparable sales	10%
Impaired commercial business loans	1,865	Liquidation value of business assets	Adjustment for differences between comparable business assets	44% - 78%

F-42

**Notes to Consolidated Financial Statements (continued)****17. Fair Values of Financial Instruments (continued)**

The two tables above exclude two impaired residential mortgage loans totaling \$140,000, an \$89,000 impaired commercial real estate loan and a \$250,000 impaired commercial business loan classified as TDRs which were measured using a discounted cash flow methodology at December 31, 2015.

The following table sets forth the carrying amount and fair value of the Corporation's financial instruments included in the consolidated balance sheet as of December 31:

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Measurements Using:			
		Total	Level 1	Level 2	Level 3
December 31, 2015:					
Financial Assets:					
Cash and cash equivalents	\$11,546	\$11,546	\$11,546	\$-	\$-
Securities available for sale	112,981	112,981	3,286	109,621	74
Loans, net	429,891	436,009	-	-	436,009
Federal bank stock	4,240	N/A	-	-	-
Accrued interest receivable	1,501	1,501	64	299	1,138
	560,159	562,037	14,896	109,920	437,221
Financial Liabilities:					
Deposits	489,887	491,591	376,409	115,182	-
FHLB advances	49,250	50,636	-	50,636	-
Accrued interest payable	179	179	5	174	-
	539,316	542,406	376,414	165,992	-
December 31, 2014:					
Financial Assets:					
Cash and cash equivalents	\$11,856	\$11,856	\$11,856	\$-	\$-
Securities available for sale	149,861	149,861	3,329	145,634	898
Loans, net	379,648	385,264	-	-	385,264
Federal bank stock	2,406	N/A	-	-	-
Accrued interest receivable	1,543	1,543	30	434	1,079
	545,314	548,524	15,215	146,068	387,241
Financial Liabilities:					
Deposits	501,819	504,230	380,685	123,545	-
FHLB advances	21,500	22,338	-	22,338	-
Accrued interest payable	199	199	32	167	-

523,518 526,767 380,717 146,050 -

This information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful.

F-43

**Notes to Consolidated Financial Statements (continued)****17. Fair Values of Financial Instruments (continued)***Off-Balance Sheet Financial Instruments*

The Corporation is party to credit related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and commercial letters of credit. Commitments to extend credit involve, to a varying degree, elements of credit and interest rate risk in excess of amounts recognized in the consolidated balance sheets. The Corporation's exposure to credit loss in the event of non-performance by the other party for commitments to extend credit is represented by the contractual amount of these commitments, less any collateral value obtained. The Corporation uses the same credit policies in making commitments as for on-balance sheet instruments. The Corporation's distribution of commitments to extend credit approximates the distribution of loans receivable outstanding.

The following table presents the notional amount of the Corporation's off-balance sheet commitment financial instruments as of December 31:

(Dollar amounts in thousands)	2015		2014	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	\$1,197	\$ 2,298	\$3,651	\$ 7,629
Unused lines of credit	6,502	48,674	2,065	44,703
	\$7,699	\$ 50,972	\$5,716	\$ 52,332

Commitments to make loans are generally made for periods of 30 days or less. Commitments to extend credit include agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments to extend credit also include unfunded commitments under commercial and consumer lines of credit, revolving credit lines and overdraft protection agreements. These lines of credit may be collateralized and usually do not contain a specified maturity date and may be drawn upon to the total extent to which the Corporation is committed.

Standby letters of credit are conditional commitments issued by the Corporation usually for commercial customers to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is

essentially the same as that involved in extending loan facilities to customers. The Corporation generally holds collateral supporting those commitments if deemed necessary. Standby letters of credit were \$146,000 and \$698,000 at December 31, 2015 and 2014, respectively. The current amount of the liability as of December 31, 2015 and 2014 for guarantees under standby letters of credit issued is not material.

F-44

**Notes to Consolidated Financial Statements (continued)****18. Emclaire Financial Corp – Condensed Financial Statements, Parent Corporation Only**

Following are condensed financial statements for the parent company as of and for the years ended December 31:

Condensed Balance Sheets (Dollar amounts in thousands)	2015	2014
Assets:		
Cash and cash equivalents	\$ 107	\$ 20
Securities available for sale	1,834	2,643
Equity in net assets of subsidiaries	51,209	49,138
Other assets	848	628
Total Assets	\$53,998	\$52,429
Liabilities and Stockholders' Equity:		
Short-term borrowed funds with affiliated subsidiary bank	\$ 1,000	\$ 1,375
Other short-term borrowed funds	-	3,000
Accrued expenses and other liabilities	159	64
Stockholders' equity	52,839	47,990
Total Liabilities and Stockholders' Equity	\$53,998	\$52,429
Condensed Statements of Income (Dollar amounts in thousands)		
	2015	2014
Income:		
Dividends from subsidiaries	\$2,731	\$1,843
Investment income	376	91
Total income	3,107	1,934
Expense:		
Interest expense	111	139
Noninterest expense	667	441
Total expense	778	580
Income before income taxes and undistributed subsidiary income	2,329	1,354
Undistributed equity in net income of subsidiary	1,688	2,562
Net income before income taxes	4,017	3,916
Income tax benefit	137	101
Net income	\$4,154	\$4,017
Comprehensive income	\$3,390	\$4,299



F-45

**Notes to Consolidated Financial Statements (continued)****18. Emclaire Financial Corp – Condensed Financial Statements, Parent Corporation Only (continued)**

Condensed Statements of Cash Flows (Dollar amounts in thousands)	2015	2014
Operating activities:		
Net income	\$4,154	\$4,017
Adjustments to reconcile net income to net cash provided by operating activities:		
Undistributed equity in net income of subsidiary	(1,688)	(2,562)
Realized gains on sales of available for sale securities, net	(298 )	-
Other, net	134	77
Net cash provided by operating activities	2,302	1,532
Investing activities:		
Sales (purchases) of investment securities	885	-
Investment in subsidiaries	(1,000)	(850 )
Net cash provided by investing activities	(115 )	(850 )
Financing activities:		
Net change in borrowings	(3,375)	850
Proceeds from issuance of common stock	8,151	-
Redemption of preferred stock (Series B)	(5,000)	-
Proceeds from exercise of stock options, including tax benefit	81	79
Dividends paid	(1,957)	(1,658)
Net cash used in financing activities	(2,100)	(729 )
Increase (decrease) in cash and cash equivalents	87	(47 )
Cash and cash equivalents at beginning of period	20	67
Cash and cash equivalents at end of period	\$107	\$20

**Notes to Consolidated Financial Statements (continued)****19. Other Noninterest Income and Expense**

Other noninterest income includes customer bank card processing fee income of \$1.0 million and \$1.0 million for 2015 and 2014, respectively.

The following summarizes the Corporation's other noninterest expenses for the years ended December 31:

(Dollar amounts in thousands)	2015	2014
Customer bank card processing	\$543	\$529
Telephone and data communications	417	417
Internet banking and bill pay	362	325
Travel, entertainment and conferences	325	302
Subscriptions	318	237
Printing and supplies	299	292
Pennsylvania shares and use taxes	295	297
Marketing and advertising	244	261
Other	244	254
Correspondent bank and courier fees	225	172
Contributions	180	189
Examinations	159	149
Postage and freight	87	97
Collections	63	58
Debit card loyalty program	9	53
Penalties on prepayment of FHLB advances	-	550
Total other noninterest expenses	\$3,770	\$4,182

**20.****Earnings Per Share**

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

<i>(Dollar amounts in thousands, except for per share amounts)</i>	For the year ended	
	December 31, 2015	2014
Earnings per common share - basic		

Edgar Filing: EMCLAIRE FINANCIAL CORP - Form 10-K

Net income	\$4,154	\$4,017
Less: Preferred stock dividends and discount accretion	75	100
Net income available to common stockholders	\$4,079	\$3,917
Average common shares outstanding	1,982,072	1,771,052
Basic earnings per common share	\$2.06	\$2.21
Earnings per common share - diluted		
Net income available to common stockholders	\$4,079	\$3,917
Average common shares outstanding	1,982,072	1,771,052
Add: Dilutive effects of assumed exercises of restricted stock and stock options	6,551	8,820
Average shares and dilutive potential common shares	1,988,623	1,779,872
Diluted earnings per common share	\$2.05	\$2.20
Stock options and restricted stock awards not considered in computing diluted earnings per share because they were antidilutive	67,000	67,000

F-47

## Notes to Consolidated Financial Statements (continued)

## 21. Accumulated Other Comprehensive Income (Loss)

The following is changes in Accumulated Other Comprehensive Income (Loss) by component, net of tax for the year ending December 31, 2015:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Total
Accumulated Other Comprehensive Income at January 1, 2015	\$ 198	\$(3,196)	\$(2,998)
Other comprehensive income before reclassification	118	(433 )	(315 )
Amounts reclassified from accumulated other comprehensive income	(564	) 115	(449 )
Net current period other comprehensive income	(446	) (318 )	(764 )
Accumulated Other Comprehensive Income at December 31, 2015	\$ (248	) \$(3,514)	\$(3,762)

The following is significant amounts reclassified out of each component of Accumulated Other Comprehensive Income (Loss) for the year ending December 31, 2015:

(Dollar amounts in thousands)	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 854	Gain on sale of securities
	(290	) Tax effect
	564	Net of tax
Amortization of defined benefit pension items:		
Prior service costs	\$ 31	Compensation and employee benefits
Actuarial gains	(205	) Compensation and employee benefits
	(174	) Total before tax
	59	Tax effect
	(115	) Net of tax
Total reclassifications for the period	\$ 449	

The following is changes in Accumulated Other Comprehensive Income (Loss) by component, net of tax for the year ending December 31, 2014:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Total
Accumulated Other Comprehensive Income at January 1, 2014	\$ (1,870	) \$(1,410)	\$(3,280)
Other comprehensive income before reclassification	2,568	(1,824)	744
Amounts reclassified from accumulated other comprehensive income	(500	) 38	(462 )
Net current period other comprehensive income	2,068	(1,786)	282
Accumulated Other Comprehensive Income at December 31, 2014	\$ 198	\$(3,196)	\$(2,998)

F-48

**Notes to Consolidated Financial Statements (continued)****21. Accumulated Other Comprehensive Income (Loss) (continued)**

The following is significant amounts reclassified out of each component of Accumulated Other Comprehensive Income (Loss) for the year ending December 31, 2014:

(Dollar amounts in thousands)	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 758	Gain on sale of securities
	(258	) Tax effect
	500	) Net of tax
Amortization of defined benefit pension items:		
Prior service costs	\$ 31	Compensation and employee benefits
Actuarial gains	(89	) Compensation and employee benefits
	(58	) Total before tax
	20	) Tax effect
	(38	) Net of tax
Total reclassifications for the period	\$ 462	

**22. Other Items**

On December 30, 2015, the Corporation announced the signing of a definitive merger agreement under which United American Savings Bank (United American) will merge into The Farmers National Bank of Emlenton in a cash transaction valued at approximately \$14.1 million. United American is a traditional community bank with one branch location in Pittsburgh Pennsylvania, with reported assets of approximately \$89.3 million at December 31, 2015.

Under the terms of the agreement, shareholders of United American will receive \$42.67 in cash for each share of United American common stock. The transaction is expected to be completed in the second quarter of 2016, subject to the satisfaction of customary closing conditions, including regulatory approval and the approval of the shareholders of United American.

F-49