

FIRST CAPITAL INC  
Form 10-Q  
August 08, 2018

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

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

Commission File No. 0-25023

First Capital, Inc.

(Exact name of registrant as specified in its charter)

Indiana

35-2056949

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(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification Number)

220 Federal Drive NW, Corydon, Indiana 47112 1-812-738-2198  
(Address of principal executive offices, zip code, telephone  
number)

Not applicable  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a small reporting company or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

(Check one): Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer   
Smaller Reporting Company  Emerging Growth Company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,356,144 shares of common stock were outstanding as of July 25, 2018.

FIRST CAPITAL, INC.

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**Signatures**

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PART I - FINANCIAL INFORMATION  
 FIRST CAPITAL, INC.  
 CONSOLIDATED BALANCE SHEETS  
 (Unaudited)

	<u>June 30,</u> <u>2018</u>	<u>December</u> <u>31,</u> <u>2017</u>
	(In thousands)	
<b>ASSETS</b>		
Cash and due from banks	\$ 16,822	\$ 19,478
Interest bearing deposits with banks	3,295	730
Federal funds sold	41,769	5,707
Total cash and cash equivalents	61,886	25,915
Interest-bearing time deposits	7,770	9,258
Securities available for sale, at fair value	251,438	271,172
Securities-held to maturity	-	1
Loans, net	419,360	409,618
Loans held for sale	2,056	2,630
Federal Home Loan Bank and other stock, at cost	1,988	1,979
Foreclosed real estate	3,391	3,971
Premises and equipment	14,608	15,031
Accrued interest receivable	2,676	2,694
Cash value of life insurance	7,959	7,279
Goodwill	6,472	6,472
Core deposit intangible	1,039	1,112
Other assets	7,434	1,824
Total Assets	\$ 788,077	\$ 758,956
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 142,700	\$ 129,828
Interest-bearing	559,136	534,734
Total deposits	701,836	664,562
Advances from Federal Home Loan Bank	-	10,000
Accrued interest payable	113	107
Accrued expenses and other liabilities	5,712	3,237
Total liabilities	707,661	677,906
<b>EQUITY</b>		
Preferred stock of \$.01 par value per share		
Authorized 1,000,000 shares; none issued	-	-

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Common stock of \$.01 par value per share Authorized 7,500,000 shares; issued 3,782,933 shares (3,762,933 in 2017); outstanding 3,356,962 shares (3,336,964 in 2017)	38	38
Additional paid-in capital	40,263	39,515
Retained earnings-substantially restricted	54,661	51,972
Unearned stock compensation	(854 )	(212 )
Accumulated other comprehensive loss	(5,482 )	(2,060 )
Less treasury stock, at cost - 425,971 shares (425,969 in 2017)	(8,315 )	(8,315 )
Total First Capital, Inc. stockholders' equity	80,311	80,938
Noncontrolling interest in subsidiary	105	112
Total equity	80,416	81,050
<b>Total Liabilities and Equity</b>	<b>\$788,077</b>	<b>\$758,956</b>

See accompanying notes to consolidated financial statements.

## PART I - FINANCIAL INFORMATION

## FIRST CAPITAL, INC.

## CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
<b>INTEREST INCOME</b>				
Loans, including fees	\$5,558	\$5,133	\$10,859	\$10,080
Securities:				
Taxable	945	971	1,897	1,904
Tax-exempt	361	362	739	691
Federal Home Loan Bank dividends	21	16	54	33
Federal funds sold and interest bearing deposits with banks	178	96	278	213
Total interest income	7,063	6,578	13,827	12,921
<b>INTEREST EXPENSE</b>				
Deposits	395	346	716	705
Advances from Federal Home Loan Bank	-	-	21	-
Total interest expense	395	346	737	705
Net interest income	6,668	6,232	13,090	12,216
Provision for loan losses	316	256	513	467
Net interest income after provision for loan losses	6,352	5,976	12,577	11,749
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	1,188	1,132	2,297	2,133
Commission income	130	131	218	245
Gain (loss) on sale of securities	(96 )	61	(95 )	61
Gain on sale of loans	290	354	530	611
Increase in cash surrender value of life insurance	85	72	128	113
Other income	139	106	184	146
Total noninterest income	1,736	1,856	3,262	3,309
<b>NONINTEREST EXPENSE</b>				
Compensation and benefits	2,942	2,714	5,836	5,434
Occupancy and equipment	414	388	827	769
Data processing	764	678	1,508	1,326
Professional fees	181	169	359	332
Advertising	103	75	188	175
Net (gain) loss on foreclosed real estate	400	(100 )	521	211
Other operating expenses	893	879	1,712	1,711
Total noninterest expense	5,697	4,803	10,951	9,958
Income before income taxes	2,391	3,029	4,888	5,100

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Income tax expense	287	835	648	1,350
Net Income	2,104	2,194	4,240	3,750
Less: net income attributable to noncontrolling interest in subsidiary	4	4	7	7
Net Income Attributable to First Capital, Inc.	\$2,100	\$2,190	\$4,233	\$3,743
Earnings per common share attributable to First Capital, Inc.:				
Basic	\$0.63	\$0.66	\$1.27	\$1.13
Diluted	\$0.63	\$0.66	\$1.27	\$1.12
Dividends per share	\$0.23	\$0.21	\$0.46	\$0.42

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Net Income	\$2,104	\$2,194	\$4,240	\$3,750
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period	(636 )	2,603	(4,651)	3,356
Income tax (expense) benefit	158	(997 )	1,157	(1,285)
Net of tax amount	(478 )	1,606	(3,494)	2,071
Less: reclassification adjustment for realized (gains) losses included in net income	96	(61 )	95	(61 )
Income tax expense (benefit)	(23 )	21	(23 )	21
Net of tax amount	73	(40 )	72	(40 )
Other Comprehensive Income (Loss), net of tax	(405 )	1,566	(3,422)	2,031
Comprehensive Income	1,699	3,760	818	5,781
Less: comprehensive income attributable to the noncontrolling interest in subsidiary	4	4	7	7
Comprehensive Income Attributable to First Capital, Inc.	\$1,695	\$3,756	\$811	\$5,774

See accompanying notes to consolidated financial statements.

## PART I - FINANCIAL INFORMATION

## FIRST CAPITAL, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited)

(In thousands, except share and per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Unearned Stock Compensation	Treasury Stock	Noncontrolling Interest	Total
Balances at January 1, 2017	\$ 38	\$ 39,515	\$ 47,051	\$ (2,277 )	\$ (300 )	\$ (8,297)	\$ 112	\$ 75,842
Net income	0	0	3,743	0	0	0	7	3,750
Other comprehensive income	0	0	0	2,031	0	0	0	2,031
Cash dividends	0	0	(1,402 )	0	0	0	(14 )	(1,416 )
Stock compensation expense	0	0	0	0	43	0	0	43
Balances at June 30, 2017	\$ 38	\$ 39,515	\$ 49,392	\$ (246 )	\$ (257 )	\$ (8,297)	\$ 105	\$ 80,250
Balances at January 1, 2018	\$ 38	\$ 39,515	\$ 51,972	\$ (2,060 )	\$ (212 )	\$ (8,315)	\$ 112	\$ 81,050
Net income	0	0	4,233	0	0	0	7	4,240
Other comprehensive loss	0	0	0	(3,422 )	0	0	0	(3,422 )
Cash dividends	0	0	(1,544 )	0	0	0	(14 )	(1,558 )
Restricted stock grants	0	748	0	0	(748 )	0	0	0
Stock compensation expense	0	0	0	0	106	0	0	106
Balances at June 30, 2018	\$ 38	\$ 40,263	\$ 54,661	\$ (5,482 )	\$ (854 )	\$ (8,315)	\$ 105	\$ 80,416

See accompanying notes to consolidated financial statements.



## PART I - FINANCIAL INFORMATION

## FIRST CAPITAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30,	
	2018	2017
	(In thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$4,240	\$3,750
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Amortization of premiums and accretion of discounts on securities, net	850	849
Depreciation and amortization expense	620	609
Deferred income taxes	(327 )	(158 )
Stock compensation expense	106	43
Increase in cash value of life insurance	(128 )	(113 )
Gain on life insurance	(94 )	(18 )
(Gain) loss on sale of securities	95	(61 )
Provision for loan losses	513	467
Proceeds from sales of loans	26,679	29,184
Loans originated for sale	(25,575)	(26,131)
Gain on sale of loans	(530 )	(611 )
Amortization of tax credit investment	164	-
Net realized and unrealized loss on foreclosed real estate	466	200
Decrease (increase) in accrued interest receivable	18	(122 )
Increase (decrease) in accrued interest payable	6	(19 )
Net change in other assets/liabilities	(799 )	(448 )
Net Cash Provided By Operating Activities	6,304	7,421
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Investment in interest-bearing time deposits	-	(990 )
Proceeds from maturities and sales of interest-bearing time deposits	1,488	2,425
Purchase of securities available for sale	(13,657)	(35,133)
Proceeds from maturities of securities available for sale	870	2,785
Proceeds from sales of securities available for sale	14,345	1,090
Principal collected on mortgage-backed obligations	12,742	12,353
Investment in cash value of life insurance	(1,000 )	-
Net increase in loans receivable	(10,355)	(14,116)
Investment in tax credit entities	(691 )	-
Proceeds from sale of foreclosed real estate	214	872
Purchase of Federal Home Loan Bank stock	(9 )	(329 )

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Purchase of premises and equipment	(123 )	(964 )
Proceeds from settlement of bank-owned life insurance policies	127	804
Net Cash Provided By (Used In) Investing Activities	3,951	(31,203)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	37,274	15,716
Repayment of advances from Federal Home Loan Bank	(10,000)	-
Dividends paid	(1,558 )	(1,416 )
Net Cash Provided By Financing Activities	25,716	14,300
Net Increase (Decrease) in Cash and Cash Equivalents	35,971	(9,482 )
Cash and cash equivalents at beginning of period	25,915	45,835
Cash and Cash Equivalents at End of Period	\$61,886	\$36,353

See accompanying notes to consolidated financial statements.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

**1. Presentation of Interim Information**

First Capital, Inc. (“Company”) is the financial holding company for First Harrison Bank (“Bank”), an Indiana chartered commercial bank and wholly-owned subsidiary. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment portfolio. First Harrison REIT, Inc. (“REIT”) is a wholly-owned subsidiary of First Harrison Holdings, Inc. that holds a portion of the Bank’s real estate mortgage loan portfolio. FHB Risk Mitigation Services, Inc. (“Captive”) is a wholly-owned insurance subsidiary of the Company that provides property and casualty insurance coverage to the Company, the Bank and the Bank’s subsidiaries, and reinsurance to ten other third party insurance captives for which insurance may not be currently available or economically feasible in the insurance marketplace. Heritage Hill, LLC is a wholly-owned subsidiary of the Bank that holds and manages certain foreclosed real estate properties.

On September 20, 2017, the Bank filed applications with the Indiana Department of Financial Institutions (“IDFI”) and the Federal Deposit Insurance Corporation (“FDIC”) to convert from a federal savings association into an Indiana chartered commercial bank (the “Conversion”). The Conversion has been completed and, as of June 30, 2018, the IDFI is the Bank’s primary regulator and the FDIC is the Bank’s primary federal regulator. The Conversion did not affect the Bank’s clients in any way and did not affect FDIC deposit insurance on eligible accounts.

Additionally, in connection with the Conversion, the Company filed an application with the Federal Reserve Bank of St. Louis to change from a savings and loan holding company to a financial holding company. This change occurred simultaneously with the Conversion discussed above.

In the opinion of management, the unaudited consolidated financial statements include all adjustments considered necessary to present fairly the financial position as of June 30, 2018, and the results of operations for the three months and six months ended June 30, 2018 and 2017 and the cash flows for the six months ended June 30, 2018 and 2017. All of these adjustments are of a normal, recurring nature. Such adjustments are the only adjustments included in the unaudited consolidated financial statements. Interim results are not necessarily indicative of results for a full year or any other period.

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial statements and are presented as permitted by the instructions to Form 10-Q. Accordingly, they do not contain certain information included in the Company’s annual audited consolidated financial statements and related footnotes for the year ended December 31, 2017 included in the Company’s Annual Report on Form 10-K.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. Certain prior period amounts have been reclassified to conform with the current period presentation. The reclassifications had no effect on net income or stockholders’ equity.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)***2. Investment Securities**

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. Investment securities at June 30, 2018 and December 31, 2017 are summarized as follows:

<i>(In thousands)</i>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
June 30, 2018				
Securities available for sale:				
Agency mortgage-backed securities	\$ 105,294	\$ 1	\$ 4,754	\$ 100,541
Agency CMO	23,168	5	511	22,662
Other debt securities:				
Agency notes and bonds	70,477	-	1,481	68,996
Municipal obligations	59,693	489	943	59,239
Total securities available for sale	\$ 258,632	\$ 495	\$ 7,689	\$ 251,438
December 31, 2017				
Securities available for sale:				
Agency mortgage-backed securities	\$ 114,902	\$ -	\$ 2,253	\$ 112,649
Agency CMO	15,660	1	338	15,323
Other debt securities:				
Agency notes and bonds	70,013	-	985	69,028
Municipal obligations	73,303	1,274	405	74,172
Total securities available for sale	\$ 273,878	\$ 1,275	\$ 3,981	\$ 271,172
Securities held to maturity:				
Agency mortgage-backed securities	\$ 1	\$ -	\$ -	\$ 1
Total securities held to maturity	\$ 1	\$ -	\$ -	\$ 1



**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(2 – continued)

Agency notes and bonds, agency mortgage-backed securities and agency collateralized mortgage obligations (“CMO”) include securities issued by the Government National Mortgage Association (“GNMA”), a U.S. government agency, and the Federal National Mortgage Association (“FNMA”), the Federal Home Loan Mortgage Corporation (“FHLMC”) and the Federal Home Loan Bank (“FHLB”), which are government-sponsored enterprises.

The amortized cost and fair value of debt securities as of June 30, 2018, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities and CMO may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	Securities Available for Sale	
	Amortized Cost	Fair Value
(In thousands)		
Due in one year or less	\$22,320	\$22,167
Due after one year through five years	58,207	56,861
Due after five years through ten years	30,999	30,505
Due after ten years	18,644	18,702
	130,170	128,235
Mortgage-backed securities and CMO	128,462	123,203
	\$258,632	\$251,438

Information pertaining to investment securities available for sale with gross unrealized losses at June 30, 2018, aggregated by investment category and the length of time that individual investment securities have been in a continuous position, follows.

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	Number of Investment Positions	Fair Value	Gross Unrealized Losses
(Dollars in thousands)			
Continuous loss position less than twelve months:			
Agency mortgage-backed securities	32	\$22,976	\$ 791
Agency CMO	11	6,688	106
Agency notes and bonds	4	9,579	90
Municipal obligations	31	15,296	287
Total less than twelve months	78	54,539	1,274
Continuous loss position more than twelve months:			
Agency mortgage-backed securities	67	77,551	3,963
Agency CMO	18	10,628	405
Agency notes and bonds	20	59,416	1,391
Municipal obligations	31	15,746	656
Total more than twelve months	136	163,341	6,415
Total securities available for sale	214	\$217,880	\$ 7,689

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(2 – continued)

Information pertaining to investment securities available for sale with gross unrealized losses at December 31, 2017, aggregated by investment category and the length of time that individual investment securities have been in a continuous position, follows. At December 31, 2017, the Company did not have any securities held to maturity with an unrealized loss.

	Number of Investment Positions	Fair Value	Gross Unrealized Losses
(Dollars in thousands)			
Continuous loss position less than twelve months:			
Agency mortgage-backed securities	37	\$37,570	\$ 400
Agency CMO	6	3,036	38
Agency notes and bonds	4	11,119	69
Municipal obligations	20	10,955	83
Total less than twelve months	67	62,680	590
Continuous loss position more than twelve months:			
Agency mortgage-backed securities	60	74,960	1,853
Agency CMO	18	11,801	300
Agency notes and bonds	19	57,909	916
Municipal obligations	29	14,667	322
Total more than twelve months	126	159,337	3,391
Total securities available for sale	193	\$222,017	\$ 3,981

Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market 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, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recover in fair value.

At June 30, 2018, the U.S. government agency debt securities, including agency notes and bonds, mortgage-backed securities and CMO, and municipal obligations in a loss position had depreciated approximately 3.4% from the amortized cost basis. All of the U.S. government agency securities and municipal obligations are issued by U.S. government agencies, government-sponsored enterprises and municipal governments, or are secured by first mortgage loans and municipal project revenues. These unrealized losses related principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As the Company has the ability to hold the debt securities until maturity, or the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

While management does not anticipate any credit-related impairment losses at June 30, 2018, additional deterioration in market and economic conditions may have an adverse impact on credit quality in the future.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(2 – continued)

During the three months ended June 30, 2018, the Company realized gross gains of \$211,000 and gross losses of \$307,000 on sales of available for sale municipal securities. During the six months ended June 30, 2018, the Company realized gross gains of \$218,000 and gross losses of \$307,000 on sales of available for sale municipal securities and gross losses of \$6,000 on sales of U.S. government agency mortgage-backed CMO's. During the three and six months ended June 30, 2017, the Company realized gross gains on sales of available for sale agency mortgage backed securities and CMO's of \$58,000 and \$3,000, respectively.

Certain available for sale debt securities were pledged to secure public fund deposits at June 30, 2018 and December 31, 2017.

**3. Loans and Allowance for Loan Losses**

The Company's loan and allowance for loan loss policies are as follows:

Loans are stated at unpaid principal balances, less net deferred loan fees and the allowance for loan losses. The Company grants real estate mortgage, commercial business and consumer loans. A substantial portion of the loan portfolio is represented by mortgage loans to customers in the Louisville, Kentucky metropolitan statistical area (MSA). The ability of the Company's customers to honor their loan agreements is largely dependent upon the real estate and general economic conditions in this area.

Loan origination and commitment fees, as well as certain direct costs of underwriting and closing loans, are deferred and amortized as a yield adjustment to interest income over the lives of the related loans using the interest method. Amortization of net deferred loan fees is discontinued when a loan is placed on nonaccrual status.

The recognition of income on a loan is discontinued and previously accrued interest is reversed, when interest or principal payments become ninety (90) days past due unless, in the opinion of management, the outstanding interest remains collectible. Past due status is determined based on contractual terms. Generally, by applying the cash receipts method, interest income is subsequently recognized only as received until the loan is returned to accrual status. The cash receipts method is used when the likelihood of further loss on the loan is remote. Otherwise, the Company applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance until the loan qualifies for return to accrual status. Interest income on impaired loans is recognized using the cost recovery method, unless the likelihood of further loss on the loan is remote.

A loan is restored to accrual status when all principal and interest payments are brought current and the borrower has demonstrated the ability to make future payments of principal and interest as scheduled, which generally requires that the borrower demonstrate a period of performance of at least six consecutive months.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

For portfolio segments other than consumer loans, the Company's practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the loan's classification as a loss by regulatory examiners, or for other reasons. A partial charge-off is recorded on a loan when the uncollectibility of a portion of the loan has been confirmed, such as when a loan is discharged in bankruptcy, the collateral is liquidated, a loan is restructured at a reduced principal balance, or other identifiable events that lead management to determine the full principal balance of the loan will not be repaid. A specific reserve is recognized as a component of the allowance for estimated losses on loans individually evaluated for impairment. Partial charge-offs on nonperforming and impaired loans are included in the Company's historical loss experience used to estimate the general component of the allowance for loan losses as discussed below. Specific reserves are not considered charge-offs in management's analysis of the allowance for loan losses because they are estimates and the outcome of the loan relationship is undetermined. At June 30, 2018, the Company had five loans on which partial charge-offs of \$97,000 had been recorded.

Consumer loans not secured by real estate are typically charged off at 90 days past due, or earlier if deemed uncollectible, unless the loans are in the process of collection. Overdrafts are charged off after 45 days past due. Charge-offs are typically recorded on loans secured by real estate when the property is foreclosed upon.

The allowance for loan losses reflects management's judgment of probable loan losses inherent in the loan portfolio at the balance sheet date. Additions to the allowance for loan losses are made by the 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 credited to the allowance.

The Company uses a disciplined process and methodology to evaluate the allowance for loan losses on at least a quarterly basis that is based upon management's periodic review of the collectibility of the loans in light of historical 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, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are individually evaluated for impairment or loans otherwise classified as doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan.

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**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The general component covers non-classified loans and classified loans that are found, upon individual evaluation, to not be impaired. Such loans are pooled by segment and losses are modeled using annualized 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 Company over the most recent twelve calendar quarters unless the historical loss experience is not considered indicative of the level of risk in the remaining balance of a particular portfolio segment, in which case an adjustment is determined by management. The Company's historical loss experience is then adjusted by an overall loss factor based on a qualitative analysis prepared by management and reviewed on a quarterly basis. The overall loss factor considers changes in underwriting standards, economic conditions, changes and trends in past due and classified loans and other internal and external factors.

Management also applies additional loss factor multiples to loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The loss factor multiples for classified loans are based on management's assessment of historical trends regarding losses experienced on classified loans in prior periods. See below for additional discussion of the overall loss factor and loss factor multiples for classified loans as of June 30, 2018 and December 31, 2017.

Management exercises significant judgment in evaluating the relevant historical loss experience and the qualitative factors. Management also monitors the differences between estimated and actual incurred loan losses for loans considered impaired in order to evaluate the effectiveness of the estimation process and make any changes in the methodology as necessary.

Management utilizes the following portfolio segments in its analysis of the allowance for loan losses: residential real estate, land, construction, commercial real estate, commercial business, home equity and second mortgage, and other consumer loans. Additional discussion of the portfolio segments and the risks associated with each segment can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include 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 by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other factors. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed \$200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of the property. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management's assessment of market factors and management's inspection of the property.

At June 30, 2018 and December 31, 2017, the recorded investments in loans secured by residential real estate properties for which formal foreclosure proceedings are in process was \$906,000 and \$588,000, respectively.

Loans at June 30, 2018 and December 31, 2017 consisted of the following:

<i>(In thousands)</i>	June 30, 2018	December 31, 2017
Real estate mortgage loans:		
Residential	\$ 135,602	\$ 136,399
Land	21,334	18,198
Residential construction	30,495	28,854
Commercial real estate	104,767	100,133
Commercial real estate construction	12,387	17,161
Commercial business loans	33,743	34,114
Consumer loans:		
Home equity and second mortgage loans	51,283	49,802
Automobile loans	40,435	38,361
Loans secured by savings accounts	1,404	1,751

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Unsecured loans	3,708	3,744
Other consumer loans	8,018	8,714
Gross loans	443,176	437,231
Less undisbursed portion of loans in process	(21,013 )	(25,020 )
Principal loan balance	422,163	412,211
Deferred loan origination fees, net	1,064	1,041
Allowance for loan losses	(3,867 )	(3,634 )
Loans, net	\$419,360	\$409,618

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table provides the components of the Company's recorded investment in loans at June 30, 2018:

	Residential Real Estate (In thousands)	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
Recorded Investment in Loans:								
Principal loan balance	\$ 135,602	\$ 21,334	\$ 21,869	\$ 104,767	\$ 33,743	\$ 51,283	\$ 53,565	\$ 422,163
Accrued interest receivable	482	94	56	250	117	206	217	1,422
Net deferred loan origination fees and costs	92	15	(8 )	(41 )	1	1,005	-	1,064
Recorded investment in loans	\$ 136,176	\$ 21,443	\$ 21,917	\$ 104,976	\$ 33,861	\$ 52,494	\$ 53,782	\$ 424,649
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	\$ 2,383	\$ 333	\$ -	\$ 259	\$ 245	\$ 76	\$ 8	\$ 3,304
Collectively evaluated for impairment	133,441	21,110	21,917	104,667	33,616	52,418	53,774	420,943
Acquired with deteriorated credit quality	352	-	-	50	-	-	-	402
Ending balance	\$ 136,176	\$ 21,443	\$ 21,917	\$ 104,976	\$ 33,861	\$ 52,494	\$ 53,782	\$ 424,649

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table provides the components of the Company's recorded investment in loans at December 31, 2017:

	Residential Real Estate (In thousands)	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
Recorded Investment in Loans:								
Principal loan balance	\$ 136,399	\$ 18,198	\$ 20,995	\$ 100,133	\$ 34,114	\$ 49,802	\$ 52,570	\$ 412,211
Accrued interest receivable	474	94	49	249	87	189	223	1,365
Net deferred loan origination fees and costs	87	17	(10 )	(42 )	2	987	-	1,041
Recorded investment in loans	\$ 136,960	\$ 18,309	\$ 21,034	\$ 100,340	\$ 34,203	\$ 50,978	\$ 52,793	\$ 414,617
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	\$ 2,907	\$ -	\$ -	\$ 401	\$ 42	\$ 73	\$ -	\$ 3,423
Collectively evaluated for impairment	133,703	18,309	21,034	99,891	34,161	50,905	52,793	410,796
Acquired with deteriorated credit quality	350	-	-	48	-	-	-	398
Ending balance	\$ 136,960	\$ 18,309	\$ 21,034	\$ 100,340	\$ 34,203	\$ 50,978	\$ 52,793	\$ 414,617

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

An analysis of the allowance for loan losses as of June 30, 2018 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$160	\$-	\$ -	\$ -	\$ 2	\$ -	\$ -	\$162
Collectively evaluated for impairment	528	148	216	1,306	415	607	485	3,705
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Ending balance	\$688	\$148	\$ 216	\$ 1,306	\$ 417	\$ 607	\$ 485	\$3,867

An analysis of the allowance for loan losses as of December 31, 2017 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$35	\$-	\$ -	\$ -	\$ 4	\$ 13	\$ -	\$52
Collectively evaluated for impairment	182	133	245	1,622	287	697	414	3,580

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Acquired with deteriorated credit quality	2	-	-	-	-	-	-	2
Ending balance	\$219	\$133	\$245	\$1,622	\$291	\$710	\$414	\$3,634

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

An analysis of the changes in the allowance for loan losses for the three months and six months ended June 30, 2018 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended June 30, 2018								
Beginning balance	\$301	\$156	\$291	\$1,520	\$276	\$680	\$407	\$3,631
Provisions for loan losses	398	(8 )	(75 )	(237 )	141	(75 )	172	316
Charge-offs	(15 )	0	0	0	0	(13 )	(138 )	(166 )
Recoveries	4	0	0	23	0	15	44	86
Ending balance	\$688	\$148	\$216	\$1,306	\$417	\$607	\$485	\$3,867
Changes in Allowance for Loan Losses for the six-months ended June 30, 2018								
Beginning balance	\$219	\$133	\$245	\$1,622	\$291	\$710	\$414	\$3,634
Provisions for loan losses	538	15	(29 )	(348 )	126	(109 )	320	513
Charge-offs	(75 )	0	0	0	(1 )	(12 )	(334 )	(422 )
Recoveries	6	0	0	32	1	18	85	142
Ending balance	\$688	\$148	\$216	\$1,306	\$417	\$607	\$485	\$3,867

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

An analysis of the changes in the allowance for loan losses for the three months and six months ended June 30, 2017 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
(In thousands)								
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended June 30, 2017								
Beginning balance	\$271	\$109	\$ 223	\$ 1,585	\$ 244	\$ 698	\$ 288	\$3,418
Provisions for loan losses	(61 )	15	83	(4 )	46	(13 )	190	256
Charge-offs	(6 )	0	0	(2 )	0	(6 )	(186 )	(200 )
Recoveries	8	0	0	4	0	1	39	52
Ending balance	\$212	\$124	\$ 306	\$ 1,583	\$ 290	\$ 680	\$ 331	\$3,526
Changes in Allowance for Loan Losses for the six-months ended June 30, 2017								
Beginning balance	\$380	\$56	\$ 80	\$ 1,670	\$ 198	\$ 683	\$ 319	\$3,386
Provisions for loan losses	(146)	68	226	(132 )	131	1	319	467
Charge-offs	(46 )	0	0	(3 )	(43 )	(6 )	(390 )	(488 )
Recoveries	24	0	0	48	4	2	83	161
Ending balance	\$212	\$124	\$ 306	\$ 1,583	\$ 290	\$ 680	\$ 331	\$3,526

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

At June 30, 2018 and December 31, 2017, management applied qualitative factor adjustments to various portfolio segments as they determined that the historical loss experience was not indicative of the level of risk in the remaining balance of those portfolio segments. As part of their analysis of qualitative factors, management considers changes in underwriting standards, economic conditions, past due loan trends, collateral valuations, loan concentrations and other internal and external factors. Had these qualitative factor adjustments not been considered, the allowance for loan losses based on historical loss factors would have been \$2.7 million and \$2.6 million lower at June 30, 2018 and December 31, 2017, respectively. These changes were made to reflect management's estimates of inherent losses in these portfolio segments at June 30, 2018 and December 31, 2017.

Management also adjusts the historical loss factors for loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The adjustments consider the increased likelihood of loss on classified loans based on the Company's separate historical experience for classified loans. Had the adjustments for classified loans not been considered, the allowance for loan losses would have been \$489,000 and \$506,000 lower at June 30, 2018 and December 31, 2017, respectively. These factors were not adjusted during the period from December 31, 2017 to June 30, 2018.

Additional discussion of the Bank's allowance for loan loss methodology can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table summarizes the Company's impaired loans as of June 30, 2018 and for the three months and six months ended June 30, 2018. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the three or six month periods ended June 30, 2018:

	At June 30, 2018			Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	Recorded Investment (In thousands)	Unpaid Principal Balance	Related Allowance	Recorded Investment	Average Interest Income Recognized	Recorded Investment	Average Interest Income Recognized
Loans with no related allowance recorded:							
Residential	\$2,128	\$ 2,357	\$ 0	\$2,327	\$ 5	\$2,449	\$ 13
Land	333	339	0	214	0	142	0
Construction	0	0	0	0	0	0	0
Commercial real estate	259	257	0	312	5	342	10
Commercial business	217	219	0	254	4	173	7
Home equity/2nd mortgage	76	85	0	77	0	71	1
Other consumer	8	0	0	8	1	5	1
	3,021	3,257	0	3,192	15	3,182	32
Loans with an allowance recorded:							
Residential	255	274	160	267	0	248	0
Land	0	0	0	0	0	0	0
Construction	0	0	0	0	0	0	0
Commercial real estate	0	0	0	0	0	0	0
Commercial business	28	30	2	28	0	29	0
Home equity/2nd mortgage	0	0	0	7	0	9	0
Other consumer	0	0	0	0	0	0	0
	283	304	162	302	0	286	0
Total:							
Residential	2,383	2,631	160	2,594	5	2,697	13
Land	333	339	0	214	0	142	0

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Construction	0	0	0	0	0	0	0
Commercial real estate	259	257	0	312	5	342	10
Commercial business	245	249	2	282	4	202	7
Home equity/2nd mortgage	76	85	0	84	0	80	1
Other consumer	8	0	0	8	1	5	1
	\$3,304	\$ 3,561	\$ 162	\$3,494	\$ 15	\$3,468	\$ 32

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table summarizes the Company's impaired loans for the three months and six months ended June 30, 2017. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the three or six month periods ended June 30, 2017:

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	Average Interest Recorded	Investment Recognized	Average Interest Recorded	Investment Recognized
Loans with no related allowance recorded:				
Residential	\$2,387	\$ 6	\$2,215	\$ 14
Land	0	0	0	0
Construction	0	0	0	0
Commercial real estate	759	6	911	8
Commercial business	72	0	73	0
Home equity/2nd mortgage	228	0	229	1
Other consumer	11	0	7	0
	3,457	12	3,435	23
Loans with an allowance recorded:				
Residential	87	0	128	0
Land	0	0	0	0
Construction	0	0	0	0
Commercial real estate	0	0	0	0
Commercial business	50	0	56	0
Home equity/2nd mortgage	23	0	19	0
Other consumer	25	0	23	0
	185	0	226	0

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Total:				
Residential	2,474	6	2,343	14
Land	0	0	0	0
Construction	0	0	0	0
Commercial real estate	759	6	911	8
Commercial business	122	0	129	0
Home equity/2nd mortgage	251	0	248	1
Other consumer	36	0	30	0
	\$3,642	\$ 12	\$3,661	\$ 23

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table summarizes the Company's impaired loans as of December 31, 2017:

	Recorded Investment	Unpaid Principal Balance	Related Allowance
	(In thousands)		
Loans with no related allowance recorded:			
Residential	\$2,695	\$ 2,948	\$ -
Land	-	-	-
Construction	-	-	-
Commercial real estate	401	535	-
Commercial business	12	12	-
Home equity/2nd mortgage	60	68	-
Other consumer	-	-	-
	3,168	3,563	-
Loans with an allowance recorded:			
Residential	212	218	35
Land	-	-	-
Construction	-	-	-
Commercial real estate	-	-	-
Commercial business	30	30	4
Home equity/2nd mortgage	13	13	13
Other consumer	-	-	-
	255	261	52
Total:			
Residential	2,907	3,166	35
Land	-	-	-
Construction	-	-	-
Commercial real estate	401	535	-

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Commercial business	42	42	4
Home equity/2nd mortgage	73	81	13
Other consumer	-	-	-
	\$3,423	\$ 3,824	\$ 52

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

Nonperforming loans consists of nonaccrual loans and loans over 90 days past due and still accruing interest. The following table presents the recorded investment in nonperforming loans at June 30, 2018 and December 31, 2017:

	June 30, 2018			December 31, 2017		
	Loans 90+ Days Nonaccrual Loans	Loans Past Due Still Accruing	Total Nonperforming Loans	Loans 90+ Days Nonaccrual Loans	Loans Past Due Still Accruing	Total Nonperforming Loans
	(In thousands)					
Residential	\$1,845	\$ -	\$ 1,845	\$2,298	\$ 109	\$ 2,407
Land	333	-	333	-	95	95
Construction	-	-	-	-	-	-
Commercial real estate	-	-	-	139	-	139
Commercial business	76	67	143	42	59	101
Home equity/2nd mortgage	62	-	62	57	-	57
Other consumer	-	30	30	-	28	28
<b>Total</b>	<b>\$2,316</b>	<b>\$ 97</b>	<b>\$ 2,413</b>	<b>\$2,536</b>	<b>\$ 291</b>	<b>\$ 2,827</b>

The following table presents the aging of the recorded investment in loans at June 30, 2018:

30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Purchased Credit Impaired Loans	Total Loans
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(In thousands)

Residential	\$2,468	\$554	\$1,099	\$4,121	\$131,703	\$ 352	\$136,176
Land	103	-	95	198	21,245	-	21,443
Construction	-	-	-	-	21,917	-	21,917
Commercial real estate	728	-	-	728	104,198	50	104,976
Commercial business	201	-	67	268	33,593	-	33,861
Home equity/2nd mortgage	125	1	-	126	52,368	-	52,494
Other consumer	297	54	30	381	53,401	-	53,782
Total	\$3,922	\$609	\$1,291	\$5,822	\$418,425	\$ 402	\$424,649

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table presents the aging of the recorded investment in loans at December 31, 2017:

	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>90 Days or More Past Due</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Purchased Credit Impaired Loans</b>	<b>Total Loans</b>
	(In thousands)						
Residential	\$2,612	\$338	\$1,255	\$4,205	\$132,405	\$ 350	\$136,960
Land	186	-	95	281	18,028	-	18,309
Construction	-	-	-	-	21,034	-	21,034
Commercial real estate	379	-	139	518	99,774	48	100,340
Commercial business	46	49	102	197	34,006	-	34,203
Home equity/2nd mortgage	468	27	13	508	50,470	-	50,978
Other consumer	420	37	28	485	52,308	-	52,793
<b>Total</b>	<b>\$4,111</b>	<b>\$451</b>	<b>\$1,632</b>	<b>\$6,194</b>	<b>\$408,025</b>	<b>\$ 398</b>	<b>\$414,617</b>

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, public information, historical payment experience, credit documentation, and current economic trends, among other factors. The Company classifies loans based on credit risk at least quarterly. The Company uses the following regulatory definitions for risk ratings:

*Special Mention:* Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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*Substandard:* Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

*Doubtful:* Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

*Loss:* Loans classified as loss are considered uncollectible and of such little value that their continuance on the institution's books as an asset is not warranted.

Loans not meeting the criteria above that are analyzed individually as part of the described process are considered to be pass rated loans.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table presents the recorded investment in loans by risk category as of the date indicated:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
<u>June 30, 2018</u>								
Pass	\$133,138	\$21,061	\$ 21,644	\$101,232	\$ 32,647	\$52,431	\$ 53,638	\$415,791
Special Mention	379	-	273	1,944	899	-	142	3,637
Substandard	798	49	-	1,800	239	1	2	2,889
Doubtful	1,861	333	-	-	76	62	-	2,332
Loss	-	-	-	-	-	-	-	-
Total	\$136,176	\$21,443	\$ 21,917	\$104,976	\$ 33,861	\$52,494	\$ 53,782	\$424,649
<u>December 31, 2017</u>								
Pass	\$133,618	\$18,003	\$ 20,173	\$97,219	\$ 33,245	\$50,919	\$ 52,629	\$405,806
Special Mention	348	157	861	1,362	734	-	161	3,623
Substandard	684	149	-	1,620	182	2	3	2,640
Doubtful	2,310	-	-	139	42	57	-	2,548
Loss	-	-	-	-	-	-	-	-
Total	\$136,960	\$18,309	\$ 21,034	\$100,340	\$ 34,203	\$50,978	\$ 52,793	\$414,617

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

The following table summarizes the Company's troubled debt restructurings (TDRs) by accrual status as of June 30, 2018 and December 31, 2017:

	June 30, 2018			Related Allowance for Loan Losses	December 31, 2017			Related Allowance for Loan Losses
	Accruing	Nonaccrual	Total		Accruing	Nonaccrual	Total	
	(In thousands)							
Troubled debt restructurings:								
Residential real estate	\$468	\$ 106	\$574	\$ -	\$487	\$ 106	\$593	\$ -
Commercial real estate	352	-	352	-	356	-	356	-
Commercial business	169	-	169	-	-	-	-	-
Home equity and 2nd mortgage	14	-	14	-	15	-	15	-
Total	\$1,003	\$ 106	\$1,109	\$ -	\$858	\$ 106	\$964	\$ -

At June 30, 2018 and December 31, 2017, there were no commitments to lend additional funds to debtors whose loan terms have been modified in a TDR.

The following table summarizes information in regard to TDRs that were restructured during the six months ended June 30, 2018:

Six months ended June 30, 2018	
Pre-Modification	Post-Modification
Number of Outstanding of Balance	Outstanding Balance

Contracts  
(Dollars in thousands)

<p>Troubled debt restructurings:</p> <p>Commercial business</p>	<p>1</p>	<p>\$ 179</p>	<p>\$ 179</p>
<p>Total</p>	<p>1</p>	<p>\$ 179</p>	<p>\$ 179</p>

For the TDR listed above, the terms of modification included the deferral of contractual principal payments. There were no TDRs that were restructured during the three months ended June 30, 2018 and the three and six months ended June 30, 2017.

There were no principal charge-offs recorded as a result of TDRs and there was no specific allowance for loan losses related to TDRs modified during the three and six months ended June 30, 2018 or 2017.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

There were no TDRs modified within the previous 12 months for which there was a subsequent payment default (defined as the loan becoming more than 90 days past due, being moved to nonaccrual status, or the collateral being foreclosed upon) during the three and six months ended June 30, 2018 and 2017. In the event that a TDR subsequently defaults, the Company evaluates the restructuring for possible impairment. As a result, the related allowance for loan losses may be increased or charge-offs may be taken to reduce the carrying amount of the loan.

*Purchased Credit Impaired (PCI) Loans*

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan and lease losses. Such loans are accounted for individually or aggregated into pools of loans based on common risk characteristics such as credit score, loan type and date of origination. In determining the estimated fair value of purchased loans or pools, management considers a number of factors including the remaining life, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, and net present value of cash flows expected to be received, among others. Purchased loans that have evidence of credit deterioration since origination for which it is deemed probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments are accounted for in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 310-30. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. The difference between the expected cash flows and the fair value at acquisition is recorded as interest income over the remaining life of the loan or pool of loans and is referred to as the accretable yield. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which is recognized as future interest income.

The following table presents the carrying amount of PCI loans accounted for under ASC 310-30 at June 30, 2018 and December 31, 2017:

<i>(In thousands)</i>	June 30, 2018	December 31, 2017
Residential real estate	\$352	\$ 350
Commercial real estate	50	48
Carrying amount	402	398
Allowance for loan losses	0	2
Carrying amount, net of allowance	\$402	\$ 396

The outstanding balance of PCI loans accounted for under ASC 310-30, including contractual principal, interest, fees and penalties was \$610,000 and \$625,000 at June 30, 2018 and December 31, 2017, respectively.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(3 – continued)

There was no allowance for loan losses related to PCI loans at June 30, 2018. The allowance for loan losses related to PCI loans was \$2,000 at December 31, 2017. There was a \$2,000 reduction of the allowance for loan losses related to PCI loans for the six-month period ended June 30, 2018. There were no net provisions for loans losses related to PCI loans for the three-month period ended June 30, 2018 or for the three-month or six-month periods ended June 30, 2017.

Accretable yield, or income expected to be collected, is as follows for the three and six month periods ended June 30, 2018 and 2017:

	Three Months Ended		Six Months Ended	
	6/30/2018	6/30/2017	6/30/2018	6/30/2017
Balance at beginning of period	\$459	\$244	\$470	\$252
New loans purchased	-	-	-	-
Accretion to income	(15 )	(14 )	(29 )	(28 )
Disposals and other adjustments	-	(17 )	-	(17 )
Reclassification (to) from nonaccretable difference	(1 )	10	2	16
Balance at end of period	\$443	\$223	\$443	\$223

**4. Qualified Affordable Housing Project Investment**

On January 19, 2018, the Bank entered into an agreement to invest in qualified affordable housing projects through a limited liability company. At June 30, 2018, the balance of the Bank's investment was \$3.8 million and is reflected in other assets on the consolidated balance sheet. The unfunded commitment related to the qualified affordable housing project investment was \$3.3 million at June 30, 2018 and is reflected in other liabilities on the consolidated balance sheet. The Bank expects to fulfill the commitment as capital calls are made through 2029.

The investment is accounted for using the proportional amortization method. During the three months ended June 30, 2018, the Bank recognized amortization expense of \$82,000, which was included in income tax expense on the consolidated statement of income. Additionally, during the three months ended June 30, 2018, the Bank recognized tax credits and other tax benefits from its qualified affordable housing project investment of \$98,000. During the six months ended June 30, 2018, the Bank recognized amortization expense of \$164,000, included in income tax expense on the consolidated statement of income and tax credits and other tax benefits from its qualified affordable housing project investment of \$196,000.

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)***5. Supplemental Disclosure for Earnings Per Share**

	Three Months Ended		Six Months Ended	
	6/30/2018	6/30/2017	6/30/2018	6/30/2017
<u>Basic</u>				
(Dollars in thousands, except for share and per share data)				
Earnings:				
Net income attributable to First Capital, Inc.	\$2,100	\$2,190	\$4,233	\$3,743
Shares:				
Weighted average common shares outstanding	3,326,797	3,323,552	3,326,632	3,323,552
Net income attributable to First Capital, Inc. per common share, basic	\$0.63	\$0.66	\$1.27	\$1.13
<u>Diluted</u>				
Earnings:				
Net income attributable to First Capital, Inc.	\$2,100	\$2,190	\$4,233	\$3,743
Shares:				
Weighted average common shares outstanding	3,326,797	3,323,552	3,326,632	3,323,552
Add: Dilutive effect of restricted stock	7,041	5,488	6,401	5,286
Weighted average common shares outstanding, as adjusted	3,333,838	3,329,040	3,333,033	3,328,838
Net income attributable to First Capital, Inc. per common share, diluted	\$0.63	\$0.66	\$1.27	\$1.12

Nonvested restricted stock shares are not considered as outstanding for purposes of computing weighted average common shares outstanding. No shares were excluded from the calculations of diluted net income per share because their effect would be anti-dilutive for the three-month and six-month periods ended June 30, 2018 and 2017.

**6. Stock Option Plan**

On May 20, 2009, the Company adopted the 2009 Equity Incentive Plan (the Plan). The Plan provides for the award of stock options, restricted stock, performance shares and stock appreciation rights. The aggregate number of shares of the Company's common stock available for issuance under the Plan may not exceed 223,000 shares.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(6 – continued)

At June 30, 2018, 184,000 shares of the Company's common stock were available for issuance under the Plan. The Company may grant both non-statutory and statutory stock options which may not have a term exceeding ten years. In the case of incentive stock options, the aggregate fair value of the stock (determined at the time the incentive stock option is granted) for which any optionee may be granted incentive options which are first exercisable during any calendar year shall not exceed \$100,000. Option prices may not be less than the fair market value of the underlying stock at the date of the grant. An award of a performance share is a grant of a right to receive shares of the Company's common stock which is contingent upon the achievement of specific performance criteria or other objectives set at the grant date. Stock appreciation rights are equity or cash settled share-based compensation arrangements whereby the number of shares that will ultimately be issued or the cash payment is based upon the appreciation of the Company's common stock. Awards granted under the Plan may be granted either alone, in addition to, or in tandem with, any other award granted under the Plan. The terms of the Plan also include provisions whereby all unearned options and restricted shares become immediately exercisable and fully vested upon a change in control.

The fair market value of stock options granted is estimated at the date of grant using an option pricing model. Expected volatilities are based on historical volatility of the Company's stock. The expected term of options granted represents the period of time that options are expected to be outstanding and is based on historical trends. The risk free rate for the expected life of the options is based on the U.S. Treasury yield curve in effect at the time of grant. As of June 30, 2018, no stock options had been granted under the Plan.

On February 20, 2018, the Company granted 20,000 restricted stock shares to directors, officers and key employees at a grant-date price of \$37.42 per share for a total of \$748,000. The restricted stock vests ratably from the grant date through July 1, 2023, with 20% of the shares vesting each year on July 1 beginning July 1, 2019. On February 17, 2015, the Company granted 19,500 restricted stock shares to directors, officers and key employees at a grant-date price of \$24.50 per share for a total of \$478,000 with a similar vesting schedule from July 1, 2016 through July 1, 2020. Compensation expense is measured based on the fair market value of the restricted stock at the grant date and is recognized ratably over the period during which the shares are earned (the vesting period). Compensation expense related to restricted stock recognized for the three-month and six-month periods ended June 30, 2018 amounted to \$57,000 and \$106,000, respectively. Compensation expense related to restricted stock recognized for the three-month and six-month periods ended June 30, 2017 amounted to \$22,000 and \$43,000, respectively.

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A summary of the Company's nonvested restricted shares under the Plan as of June 30, 2018 and changes during the six-month period then ended is presented below.

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2018	10,500	\$ 24.50
Granted	20,000	\$ 37.42
Vested	800	\$ 32.58
Forfeited	-	-
Nonvested at June 30, 2018	29,700	\$ 32.98

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**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(6 – continued)

There were 800 restricted shares that vested during the six-month period ended June 30, 2018, upon the retirement of a director. The total fair value of restricted shares that vested during the six-month period ended June 30, 2018 was \$29,000. At June 30, 2018, there was \$854,000 of total unrecognized compensation expense related to nonvested restricted shares. The compensation expense is expected to be recognized over the remaining vesting period of 5.0 years.

**7. Supplemental Disclosures of Cash Flow Information**

	<b>Six Months Ended June 30, 2018 2017</b>	
	<i>(In thousands)</i>	
Cash payments for:		
Interest	\$731	\$724
Taxes (net of refunds received)	705	1,430
Noncash investing activities:		
Transfers from loans to real estate acquired through foreclosure	176	416
Proceeds from sales of foreclosed real estate financed through loans	-	15

**8. Fair Value Measurements**

FASB ASC Topic 820, *Fair Value Measurements*, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities

(Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are described as follows:

Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets

Level 2: Inputs to the valuation methodology include quoted market prices for similar assets or liabilities in active markets; quoted market prices for identical or similar assets or liabilities in markets that are not active; or inputs that are derived principally from or can be corroborated by observable market data by correlation or other means.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using discounted cash flow methodologies, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth on the following page. These valuation methodologies were applied to all of the Company's financial and nonfinancial assets carried at fair value or the lower of cost or fair value. The table below presents the balances of assets measured at fair value on a recurring and nonrecurring basis as of June 30, 2018 and December 31, 2017. The Company had no liabilities measured at fair value as of June 30, 2018 or December 31, 2017.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(8 – continued)

(In thousands)	Carrying Value			Total
	Level 1	Level 2	Level 3	
June 30, 2018				
Assets Measured on a Recurring Basis				
Securities available for sale:				
Agency mortgage-backed securities	\$-	\$100,541	\$-	\$100,541
Agency CMO	-	22,662	-	22,662
Agency notes and bonds	-	68,996	-	68,996
Municipal obligations	-	59,239	-	59,239
Total securities available for sale	\$-	\$251,438	\$-	\$251,438
Assets Measured on a Nonrecurring Basis				
Impaired loans:				
Residential real estate	\$-	\$-	\$2,223	\$2,223
Land	-	-	333	333
Commercial real estate	-	-	259	259
Commercial business	-	-	243	243
Home equity and second mortgage	-	-	76	76
Other consumer	-	-	8	8
Total impaired loans	\$-	\$-	\$3,142	\$3,142
Loans held for sale	\$-	\$2,056	\$-	\$2,056
Foreclosed real estate:				
Residential real estate	\$-	\$-	\$282	\$282
Commercial real estate	-	-	3,109	3,109
Total foreclosed real estate	\$-	\$-	\$3,391	\$3,391
December 31, 2017				
Assets Measured on a Recurring Basis				
Securities available for sale:				
Agency mortgage-backed securities	\$-	\$112,649	\$-	\$112,649
Agency CMO	-	15,323	-	15,323
Agency notes and bonds	-	69,028	-	69,028
Municipal obligations	-	74,172	-	74,172

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Total securities available for sale	\$-	\$271,172	\$-	\$271,172
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Assets Measured on a Nonrecurring Basis

Impaired loans:

Residential real estate	\$-	\$-	\$2,872	\$2,872
Commercial real estate	-	-	401	401
Commercial business	-	-	38	38
Home equity and second mortgage	-	-	60	60
Total impaired loans	\$-	\$-	\$3,371	\$3,371

Loans held for sale	\$-	\$2,630	\$-	\$2,630
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Foreclosed real estate:

Residential real estate	\$-	\$-	\$443	\$443
Commercial real estate	-	-	3,528	3,528
Total foreclosed real estate	\$-	\$-	\$3,971	\$3,971

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(8 – continued)

Fair value is based upon quoted market prices, where available. If quoted market prices are not available, fair value is based on internally developed models or obtained from third parties that primarily use, as inputs, observable market-based parameters or a matrix pricing model that employs the Bond Market Association's standard calculations for cash flow and price/yield analysis and observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value, or the lower of cost or fair value. These adjustments may include unobservable parameters. Any such valuation adjustments have been applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

***Securities Available for Sale.*** Securities classified as available for sale are reported at fair value on a recurring basis. These securities are classified as Level 1 of the valuation hierarchy where quoted market prices from reputable third-party brokers are available in an active market. If quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service. These securities are reported using Level 2 inputs and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. Changes in fair value of securities available for sale are recorded in other comprehensive income, net of income tax effect.

***Impaired Loans.*** Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly. The fair value of impaired loans is classified as Level 3 in the fair value hierarchy.

Impaired loans are carried at the present value of estimated future cash flows using the loan's effective interest rate or the fair value of collateral less estimated costs to sell if the loan is collateral dependent. At June 30, 2018 and December 31, 2017, all impaired loans were considered to be collateral dependent for the purpose of determining fair value. Collateral may be real estate and/or business assets, including equipment, inventory and/or accounts receivable. The fair value of the collateral is generally determined based on real estate appraisals or other independent evaluations by qualified professionals, adjusted for estimated costs to sell the property, costs to complete or repair the property and other factors to reflect management's estimate of the fair value of the collateral given the current market conditions

and the condition of the collateral. At June 30, 2018, the significant unobservable inputs used in the fair value measurement of impaired loans included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral and estimated costs to sell the collateral ranging from 14% to 100%, with a weighted average discount of 70%. At December 31, 2017, the discount from appraised value ranged from 14% to 62%, with a weighted average discount of 39%. The Company recognized provisions for loan losses of \$137,000 and \$5,000 for the six months ended June 30, 2018 and 2017, respectively, for impaired loans. The Company recognized provisions for loan losses of \$72,000 and \$3,000 for the three months ended June 30, 2018 and June 30, 2017, respectively, for impaired loans.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(8 – continued)

***Loans Held for Sale.*** Loans held for sale are carried at the lower of cost or market value. The portfolio is comprised of residential real estate loans and fair value is based on specific prices of underlying contracts for sales to investors. These measurements are classified as Level 2.

***Foreclosed Real Estate.*** Foreclosed real estate is reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly. The fair value of foreclosed real estate is classified as Level 3 in the fair value hierarchy.

Foreclosed real estate is reported at fair value less estimated costs to dispose of the property. The fair values are determined by real estate appraisals which are then discounted to reflect management's estimate of the fair value of the property given current market conditions and the condition of the collateral. At June 30, 2018, the significant unobservable inputs used in the fair value measurement of foreclosed real estate included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral and estimated costs to sell the property ranging from 10% to 79%, with a weighted average of 51%. At December 31, 2017, the discount from appraised value ranged from 17% to 75%, with a weighted average of 45%. The Company recognized losses of \$419,000 to write down foreclosed real estate for the three and six months ended June 30, 2018. The Company recognized losses of \$228,000 to write down foreclosed real estate for the six months ended June 30, 2017 and there were no charges to write down foreclosed real estate recognized in income for the three months ended June 30, 2017.

There have been no changes in the valuation techniques and related inputs used for assets measured at fair value on a recurring and nonrecurring basis during the six month periods ended June 30, 2018 and 2017. There were no transfers into or out of the Company's Level 3 financial assets for the six month periods ended June 30, 2018 and 2017. In addition, there were no transfers into or out of Levels 1 and 2 of the fair value hierarchy during the six month periods ended June 30, 2018 and 2017.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(8 – continued)

GAAP requires disclosure of the fair value of financial assets and financial liabilities, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The estimated fair values of the Company's financial instruments are as follows:

(In thousands)	Carrying Value	Fair Value	Fair Value Measurements Using		
			Level 1	Level 2	Level 3
<b>June 30, 2018</b>					
Financial assets:					
Cash and cash equivalents	\$61,886	\$61,886	\$61,886	\$-	\$-
Interest-bearing time deposits	7,770	7,686	-	7,686	-
Securities available for sale	251,438	251,438	-	251,438	-
Loans held for sale	2,056	2,104	-	2,104	-
Loans, net	419,360	411,787	-	-	411,787
FHLB and other stock	1,988	N/A	N/A	N/A	N/A
Accrued interest receivable	2,676	2,676	-	2,676	-
Financial liabilities:					
Deposits	701,836	699,878	-	-	699,878
Accrued interest payable	113	113	-	113	-
<b>December 31, 2017:</b>					
Financial assets:					
Cash and cash equivalents	\$25,915	\$25,915	\$25,915	\$-	\$-
Interest-bearing time deposits	9,258	9,220	-	9,220	-
Securities available for sale	271,172	271,172	-	271,172	-
Securities held to maturity	1	1	-	1	-
Loans held for sale	2,630	2,678	-	2,678	-
Loans, net	409,618	404,931	-	-	404,931
FHLB and other stock	1,979	N/A	N/A	N/A	N/A
Accrued interest receivable	2,694	2,694	-	2,694	-

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Financial liabilities:

Deposits	664,562	663,006	-	-	663,006
FHLB advances	10,000	10,000	-	10,000	-
Accrued interest payable	107	107	-	107	-

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**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(8 – continued)

The carrying amounts in the preceding table are included in the consolidated balances sheets under the applicable captions. The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

**Cash and Cash Equivalents**

For cash and short-term investments, including cash and due from banks, interest-bearing deposits with banks with original maturities of 90 days or less, money market funds, and federal funds sold, the carrying amount is a reasonable estimate of fair value.

**Investment Securities and Interest-Bearing Time Deposits**

For marketable equity securities, the fair values are based on quoted market prices. For debt securities and interest-bearing time deposits, the Company obtains fair value measurements from an independent pricing service and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. For FHLB stock, a restricted equity security, it is not practical to determine the fair value due to restrictions place on transferability.

**Loans**

The fair value of loans, excluding loans held for sale, is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and terms. Impaired loans are valued at the lower of their carrying value or fair value, as previously described. The carrying amount of accrued interest receivable approximates its fair value. The fair value of loans held for sale is based on specific prices of

underlying contracts for sale to investors.

### **Deposits**

The fair value of demand deposits, savings accounts, money market deposit accounts and other transaction accounts is the amount payable on demand at the balance sheet date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

### **FHLB Advances**

The fair value of FHLB advances is estimated by discounting the future cash flows at current interest rates for FHLB advances of similar maturities.

**FIRST CAPITAL, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)***9. Revenue from Contracts with Customers**

As of January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, using the modified retrospective approach. The adoption of the ASU had no material impact on the measurement or recognition of revenue; however, additional disclosures have been added in accordance with the ASU. See Note 10 for additional information on this new accounting standard.

All of the Company’s revenue from contracts with customers in the scope of FASB ASC 606 is recognized within noninterest income. The following table presents the Company’s sources of noninterest income for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	2018	2017	2018	2017
	(In thousands)			
Service charges on deposit accounts	\$1,188	\$1,132	\$2,297	\$2,133
Investment advisory income	130	131	218	245
Revenue from contracts with customers	1,318	1,263	2,515	2,378
Gain on sale of loans and securities	194	415	435	672
Increase in cash value of life insurance	85	72	128	113
Other	139	106	184	146
Other noninterest income	418	593	747	931
Total noninterest income	\$1,736	\$1,856	\$3,262	\$3,309

A description of the Company’s revenue streams accounted for under FASB ASC 606 follows:

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

***Interchange Income:*** The Company earns interchange fees from debit cardholder transactions conducted through a payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. Interchange income is included in service charges on deposit accounts.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(9 – continued)

***Investment Advisory Income:*** The Company earns trust, insurance commissions, brokerage commissions and annuities income from its contracts with trust customers to manage assets for investment, and/or to transact on their accounts. These fees are primarily earned over time as the Company provides the contracted monthly or quarterly services and are generally assessed based on a tiered scale of the market value of assets under management (AUM) at month-end. Fees that are transaction based, including trade execution services, are recognized at the point in time that the transaction is executed (i.e., the trade date). Other related fees, which are based on a fixed fee schedule, are recognized when the services are rendered.

**10. Recent Accounting Pronouncements**

The following are summaries of recently issued or adopted accounting pronouncements that impact the accounting and reporting practices of the Company:

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The update provides a five-step revenue recognition model for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are included in the scope of other standards). The guidance requires an entity to recognize the 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. For public entities, the guidance was originally to be effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. However, with the issuance of ASU No. 2015-14 in August 2015, the FASB deferred the effective date of ASU No. 2014-09 by one year for all entities, making the amendments effective for public entities for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. The adoption of this update as of January 1, 2018 did not have a material impact on the Company's consolidated financial position or results of operations. See Note 9 for further discussion.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance addresses certain aspects of

recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The adoption of this update as of January 1, 2018 did not have a material impact on the Company's consolidated financial position or results of operations.

**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(10 – continued)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The guidance supersedes existing guidance on accounting for leases with the main difference being that operating leases are to be recorded in the statement of financial position as right-of-use assets and lease liabilities, initially measured at the present value of the lease payments. For operating leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and liabilities. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the guidance is permitted. In transition, entities are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. Management is evaluating the new guidance, but does not expect the adoption of this update to have a material impact on the Company's consolidated financial position or results of operations.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. The update replaces the incurred loss methodology for recognizing credit losses under current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Under the new guidance, an entity will measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. The expected loss model will apply to loans and leases, unfunded lending commitments, held-to-maturity debt securities and other debt instruments measured at amortized cost. The impairment model for available-for-sale debt securities will require the recognition of credit losses through a valuation allowance when fair value is less than amortized cost, regardless of whether the impairment is considered to be other-than-temporary. For the Company, the amendments in the update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently assessing the impact the guidance will have upon adoption, but management expects to recognize a one-time cumulative-effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. However, the magnitude of the adjustment is unknown. In planning for the implementation of ASU 2016-13, the Company has formed a current expected credit loss (“CECL”) implementation team consisting of members of senior management that meets on a periodic basis and is currently evaluating software solutions, data requirements and loss methodologies.



**FIRST CAPITAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)*

(10 – continued)

In March 2017, the FASB issued ASU No. 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20) – Premium Amortization on Purchased Callable Debt Securities*. The update shortens the amortization period for certain callable debt securities held at a premium. Specifically, the update requires the premium to be amortized to the earliest call date. The update does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments in the update are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

**MANAGEMENT’S DISCUSSION AND  
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FIRST CAPITAL, INC.

Safe Harbor Statement for Forward-Looking Statements

This Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not historical facts nor guarantees of future performance; rather they are statements based on the Company’s current expectations regarding its business strategies and their intended results and its future performance. Forward-looking statements can be identified by use of the words “expects,” “believes,” “anticipates,” “intends,” “could,” “should” and similar expressions. Forward-looking statements include, but are not limited to, statements regarding estimated cost savings, plans and objectives for future operations, and the Company’s business and growth strategies.

Numerous risks and uncertainties could cause or contribute to the Company’s actual results, performance and achievements being materially different from those expressed or implied by the forward-looking statements. Factors that may cause or contribute to these differences include, without limitation, general economic conditions, including changes in market interest rates and changes in monetary and fiscal policies of the federal government; the ability of the Company to execute its business plan; legislative and regulatory changes; the quality and composition of the loan and investment securities portfolio; loan demand; deposit flows; competition; and changes in accounting principles and guidelines. Additional factors that may affect our results are discussed in Part II of this Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2017 under “Item 1A. Risk Factors.” These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. These forward-looking statements are made only as of the date of this Form 10-Q and, except as required by applicable law or regulation, the Company assumes no obligation and disclaims any obligation to update any forward-looking statements.

**Critical Accounting Policies**

During the six months ended June 30, 2018, there was no significant change in the Company’s critical accounting policies or the application of critical accounting policies as disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

## Financial Condition

Total assets increased \$29.1 million from \$759.0 million at December 31, 2017 to \$788.1 million at June 30, 2018, an increase of 3.8%.

Net loans receivable (excluding loans held for sale) increased \$9.8 million from \$409.6 million at December 31, 2017 to \$419.4 million at June 30, 2018. Commercial real estate loans, land loans and home equity and second mortgage loans increased \$4.6 million, \$3.1 million and \$1.5 million, respectively, during the six months ended June 30, 2018.

Securities available for sale decreased \$19.8 million from \$271.2 million at December 31, 2017 to \$251.4 million at June 30, 2018. Purchases of \$13.7 million of securities classified as available for sale were made during the six months ended June 30, 2018 and consisted primarily of municipal bonds and U.S. government agency notes and bonds and mortgage-backed securities. Principal repayments and maturities of available for sale securities totaled \$12.7 million and \$870,000, respectively, during the six months ended June 30, 2018. Municipal bonds and U.S. government agency mortgage-backed CMO's with a value of \$14.4 million were sold during the six months ended June 30, 2018. In addition, unrealized losses on securities available for sale increased \$4.7 million during the six months ended June 30, 2018.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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**FIRST CAPITAL, INC.**

Cash and cash equivalents increased from \$25.9 million at December 31, 2017 to \$61.9 million at June 30, 2018, primarily due to excess liquidity from increases in deposit balances and sales of securities, partially offset by the increase in loans.

Total deposits increased 5.6% from \$664.6 million at December 31, 2017 to \$701.8 million at June 30, 2018. Interest bearing checking accounts, noninterest-bearing checking accounts and savings accounts increased \$22.0 million, \$12.9 million and \$5.0 million, respectively, during the six months ended June 30, 2018 primarily due to new accounts and normal balance fluctuations, while time deposits decreased \$2.6 million during the period.

FHLB borrowings decreased \$10.0 million from December 31, 2017 to June 30, 2018 as the Bank paid off all outstanding advances during the period.

Total stockholders' equity attributable to the Company decreased from \$80.9 million at December 31, 2017 to \$80.3 million at June 30, 2018, primarily due to a \$3.4 million increase in the net unrealized loss on available for sale securities partially offset by a \$2.7 million increase in retained net income during the six months ended June 30, 2018. The increase in the net unrealized loss on available for sale securities during the period is primarily due to changes in long-term market interest rates.

**Results of Operations**

**Net income for the six-month periods ended June 30, 2018 and 2017.** Net income attributable to the Company was \$4.2 million (\$1.27 per share) for the six months ended June 30, 2018 compared to \$3.7 million (\$1.12 per share) for the same time period in 2017. The increase is primarily due to an increase in net interest income after provision for

loan losses and a decrease in income tax expense partially offset by an increase in noninterest expense.

**Net income for the three-month periods ended June 30, 2018 and 2017.** Net income attributable to the Company was \$2.1 million (\$0.63 per share) for the three months ended June 30, 2018 compared to \$2.2 million (\$0.66 per share) for the three months ended June 30, 2017. The decrease in net income for 2018 is primarily due to losses on foreclosed real estate and sales of securities during the quarter ended June 30, 2018.

**Net interest income for the six-month periods ended June 30, 2018 and 2017.** Net interest income increased \$874,000 for the six months ended June 30, 2018 compared to the same period in 2017 primarily due to increases in interest-earning assets and the interest rate spread.

Total interest income increased \$906,000 for the six months ended June 30, 2018 compared to the same period in 2017. For the six months ended June 30, 2018, the average balance of interest-earning assets and their tax-equivalent yield were \$719.8 million and 3.90%, respectively. During the same period in 2017, the average balance of those assets was \$707.7 million and the tax-equivalent yield was 3.76%. The average tax-equivalent yield increased when comparing the two periods despite being negatively impacted by the Tax Cuts and Jobs Act (“TCJA”) signed into law on December 22, 2017 as the yield would have been 3.96% for 2018 using the 34% federal corporate tax rate in effect for 2017 as opposed to the 21% rate in effect for 2018.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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**FIRST CAPITAL, INC.**

Total interest expense increased \$32,000 for the six months ended June 30, 2018 compared to the same period in 2017. The average balance of interest-bearing liabilities increased from \$545.3 million for 2017 to \$548.0 million for 2018. The average rate paid on interest-bearing liabilities increased from 0.26% to 0.27% when comparing the two periods. As a result of the changes in interest-earning assets and interest-bearing liabilities, the interest rate spread on a tax-equivalent basis increased from 3.50% for the six months ended June 30, 2017 to 3.63% for the same period in 2018.

**Net interest income for the three-month periods ended June 30, 2018 and 2017.** Net interest income increased \$436,000 for the three months ended June 30, 2018 compared to the three months ended June 30, 2017 primarily due to increases in interest-earning assets and the tax-equivalent yield on interest-earning assets.

Total interest income increased \$485,000 for the three months ended June 30, 2018 compared to the same period in 2017. For the three months ended June 30, 2018, the average balance of interest-earning assets and their tax-equivalent yield were \$728.6 million and 3.93%, respectively. During the same period in 2017, the average balance of those assets was \$711.1 million and the tax-equivalent yield was 3.81%. The changes in balances and yields are primarily due to loan growth and an increase in short-term interest rates.

Total interest expense increased \$49,000 for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. The average balance of interest-bearing liabilities increased from \$543.9 million to \$555.2 million when comparing the two periods and the average rate paid on those liabilities increased from 0.25% for the three months ended June 30, 2017 to 0.28% for the same period in 2018. As a result, the tax-equivalent interest rate spread increased from 3.56% for the three months ended June 30, 2017 to 3.65% for the three months ended June 30, 2018.

**Provision for loan losses.** Based on management's analysis of the allowance for loan losses, the provision for loan losses increased from \$467,000 for the six-month period ended June 30, 2017 to \$513,000 for the same period in 2018 and from \$256,000 for the three months ended June 30, 2017 to \$316,000 for the three months ended June 30, 2018. The Bank recognized net charge-offs of \$280,000 for the six months ended June 30, 2018 compared to \$327,000 during the same period in 2017.

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered adequate by management to provide for probable known and inherent loan losses based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specified impaired loans and economic conditions. Although management uses the best information available, future adjustments to the allowance may be necessary due to changes in economic, operating, regulatory and other conditions that may be beyond the Bank's control. While the Bank maintains the allowance for loan losses at a level that it considers adequate to provide for estimated losses, there can be no assurance that further additions will not be made to the allowance for loan losses and that actual losses will not exceed the estimated amounts.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to groups of loans, determining and measuring impairment of individual loans based on the present value of expected future cash flows or the fair value of collateral, and determining and measuring impairment for groups of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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The allowance for loan losses was \$3.9 million at June 30, 2018 and \$3.6 million at December 31, 2017. Management has deemed these amounts as adequate at each date based on its best estimate of probable known and inherent loan losses at each date. At June 30, 2018, nonperforming loans amounted to \$2.4 million compared to \$2.8 million at December 31, 2017. Included in nonperforming loans were loans 90 days or more past due and still accruing interest of \$97,000 and \$291,000 at June 30, 2018 and December 31, 2017, respectively. These loans were accruing interest because the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery. At June 30, 2018 and December 31, 2017, nonaccrual loans amounted to \$2.3 million and \$2.5 million, respectively.

**Noninterest income for the six-month periods ended June 30, 2018 and 2017.** Noninterest income for the six months ended June 30, 2018 decreased \$47,000 compared to the six months ended June 30, 2017. The decrease was primarily due to decreases in gains on the sale of securities and gains on the sale of loans of \$156,000 and \$81,000, respectively, when comparing the two periods, partially offset by a \$164,000 increase in service charges on deposit accounts.

**Noninterest income for the three-month periods ended June 30, 2018 and 2017.** Noninterest income for the quarter ended June 30, 2018 decreased \$120,000 to \$1.7 million compared to the quarter ended June 30, 2017. The decrease was primarily due to \$157,000 and \$64,000 decreases in gains on the sale of securities and gains on the sale of loans, respectively. This was partially offset by a \$56,000 increase in service charges on deposit accounts. Losses totaling \$96,000 were recorded during the quarter ended June 30, 2018 due to the sale of certain municipal securities during the quarter.

**Noninterest expense for the six-month periods ended June 30, 2018 and 2017.** Noninterest expense for the six months ended June 30, 2018 increased \$1.0 million compared to the same period in 2017 due primarily to increases in compensation and benefit expense, net losses on foreclosed real estate and data processing expense of \$402,000, \$310,000 and \$182,000, respectively, when comparing the two periods.

**Noninterest expense for the three-month periods ended June 30, 2018 and 2017.** Noninterest expense for the quarter ended June 30, 2018 increased \$894,000 compared to the quarter ended June 30, 2017 primarily due to increases in net loss on foreclosed real estate of \$500,000, compensation and benefit expense of \$228,000 and data processing expense of \$86,000 when comparing the two periods.

**Income tax expense.** Income tax expense for the six-month period ended June 30, 2018 was \$648,000, for an effective tax rate of 13.3%, compared to \$1.4 million, for an effective tax rate of 26.5%, for the same period in 2017. For the three-month period ended June 30, 2018, income tax expense and the effective tax rate were \$287,000 and 12.0%, respectively, compared to \$835,000 and 27.6%, respectively, for the same period in 2017. The decrease is primarily due to the previously mentioned TCJA, the Bank's investment in a tax credit entity during 2018 and an increase in nontaxable income.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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FIRST CAPITAL, INC.**

**Liquidity and Capital Resources**

The Bank's primary sources of funds are customer deposits, proceeds from loan repayments, maturing securities and FHLB advances. While loan repayments and maturities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At June 30, 2018, the Bank had cash and cash equivalents of \$61.9 million and securities available-for-sale with a fair value of \$251.4 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB of Indianapolis and additional collateral eligible for repurchase agreements.

The Bank's primary investing activity is the origination of one-to-four family mortgage loans and commercial real estate loans and, to a lesser extent, consumer, multi-family, commercial business and residential construction loans. The Bank also invests in U.S. Government and agency securities and mortgage-backed securities issued by U.S. Government agencies.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company, on a stand-alone basis, is responsible for paying any dividends declared to its shareholders. The Board of Directors of the Company also has authorized the repurchase of shares of its common stock. The Company's primary source of income is dividends received from the Bank. The amount of dividends that the Bank may declare and pay to the Company in any calendar year, without the receipt of prior approval from the IDFI, cannot exceed net income for that year to date plus retained net income (as defined under Indiana law) for the preceding two calendar years. On a stand-alone basis, the Company had liquid assets of \$2.1 million at June 30, 2018.

The Bank is required to maintain specific amounts of capital pursuant to regulatory requirements. As of June 30, 2018, the Bank was in compliance with all regulatory capital requirements that were effective as of such date with Tier 1 capital to average assets, common equity Tier 1 capital to risk-weighted assets, Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets ratios of 9.6%, 14.0%, 14.0% and 14.7%, respectively. The regulatory requirements at that date to be considered “well-capitalized” under applicable regulations were 5.0%, 6.5%, 8.0% and 10.0%, respectively. At June 30, 2018, the Bank was considered “well-capitalized” under applicable regulatory guidelines.

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**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF FINANCIAL CONDITION AND  
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FIRST CAPITAL, INC.

**Off-Balance Sheet Arrangements**

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with GAAP, are not recorded on the Company's financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are primarily used to manage customers' requests for funding and take the form of loan commitments and letters of credit. A further presentation of the Company's off-balance sheet arrangements is presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

For the six months ended June 30, 2018, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows.

## **PART I – ITEM 3**

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES**

#### **ABOUT MARKET RISK**

##### **FIRST CAPITAL, INC.**

**Qualitative Aspects of Market Risk.** Market risk is the risk that the estimated fair value of the Company's assets and liabilities will decline as a result of changes in interest rates or financial market volatility, or that the Company's net income will be significantly reduced by interest rate changes.

The Company's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates. The Company has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. In order to reduce the exposure to interest rate fluctuations, the Company has developed strategies to manage its liquidity, shorten its effective maturities of certain interest-earning assets and decrease the interest rate sensitivity of its asset base. Management has sought to decrease the average maturity of its assets by emphasizing the origination of short-term commercial and consumer loans, all of which are retained by the Company for its portfolio. The Company relies on retail deposits as its primary source of funds. Management believes retail deposits, compared to brokered deposits, reduce the effects of interest rate fluctuations because they generally represent a more stable source of funds.

**Quantitative Aspects of Market Risk.** The Company does not maintain a trading account for any class of financial instrument nor does the Company engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Company is not subject to foreign currency exchange rate risk or commodity price risk.

Potential cash flows, sales, or replacement value of many of our assets and liabilities, especially those that earn or pay interest, are sensitive to changes in the general level of interest rates. This interest rate risk arises primarily from our normal business activities of gathering deposits, extending loans and investing in investment securities. Many factors affect the Company's exposure to changes in interest rates, such as general economic and financial conditions, customer preferences, historical pricing relationships, and re-pricing characteristics of financial instruments. The Company's earnings can also be affected by the monetary and fiscal policies of the U.S. Government and its agencies, particularly the Federal Reserve Board.

An element in the Company's ongoing process is to measure and monitor interest rate risk using a Net Interest Income at Risk simulation to model the interest rate sensitivity of the balance sheet and to quantify the impact of changing interest rates on the Company. The model quantifies the effects of various possible interest rate scenarios on projected net interest income over a one-year horizon. The model assumes a semi-static balance sheet and measures the impact on net interest income relative to a base case scenario of hypothetical changes in interest rates over twelve months and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The scenarios include prepayment assumptions, changes in the level of interest rates, the shape of the yield curve, and spreads between market interest rates in order to capture the impact from re-pricing, yield curve, option, and basis risks.

**PART I – ITEM 3****QUANTITATIVE AND QUALITATIVE DISCLOSURES****ABOUT MARKET RISK****FIRST CAPITAL, INC.**

Results of the Company’s simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company’s net interest income could change as follows over a one-year horizon, relative to our base case scenario, based on June 30, 2018 and December 31, 2017 financial information:

Immediate Change in the Level of Interest Rates	At June 30, 2018		At December 31, 2017	
	One Year Horizon		One Year Horizon	
	Dollar Change	Percent Change	Dollar Change	Percent Change
	(Dollars in thousands)			
300bp	\$(142)	(0.53)%	\$(160)	(0.62)%
200bp	(287)	(1.08)	(221)	(0.85)
100bp	(109)	(0.41)	(96 )	(0.37)
Static	-	-	-	-
(100)bp	59	0.22	(584)	(2.25)

At June 30, 2018, the Company’s simulated exposure to a change in interest rates shows that an immediate and sustained increase in rates of 1.00%, 2.00% or 3.00% would decrease the Company’s net interest income over a one year horizon compared to a flat interest rate scenario. Alternatively, an immediate and sustained decrease in rates of 1.00% would increase the Company’s net interest income over a one year horizon compared to a flat interest rate scenario. At December 31, 2017, all scenarios described would have resulted in a decrease of the Company’s net interest income over a one year horizon compared to a flat interest scenario.

The Company also has longer term interest rate risk exposure, which may not be appropriately measured by Net Interest Income at Risk modeling. Therefore, the Company also uses an Economic Value of Equity (“EVE”) interest rate sensitivity analysis in order to evaluate the impact of its interest rate risk on earnings and capital. This is measured by

computing the changes in net EVE for its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. EVE modeling involves discounting present values of all cash flows for on and off balance sheet items under different interest rate scenarios and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The discounted present value of all cash flows represents the Company's EVE and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. The amount of base case EVE and its sensitivity to shifts in interest rates provide a measure of the longer term re-pricing and option risk in the balance sheet.

**PART I – ITEM 3****QUANTITATIVE AND QUALITATIVE DISCLOSURES****ABOUT MARKET RISK****FIRST CAPITAL, INC.**

Results of the Company's simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company's EVE could change as follows, relative to the Company's base case scenario, based on June 30, 2018 and December 31, 2017 financial information:

Immediate Change in the Level of Interest Rates	At June 30, 2018			Economic Value of Equity as a Percent of Present Value of Assets		
	Dollar	Dollar	Percent	EVE Ratio	Change	
	Amount	Change	Change			
300bp	\$107,508	\$(2,299 )	(2.09 )%	14.93	% 65	bp
200bp	109,056	(751 )	(0.68 )	14.81	53	bp
100bp	109,853	46	0.04	14.60	32	bp
Static	109,807	-	-	14.28	0	bp
(100)bp	104,202	(5,605 )	(5.10 )	13.27	(101 )	bp

Immediate Change in the Level of Interest Rates	At December 31, 2017			Economic Value of Equity as a Percent of Present Value of Assets		
	Dollar	Dollar	Percent	EVE Ratio	Change	
	Amount	Change	Change			
300bp	\$105,691	\$(2,354 )	(2.18 )%	15.11	% 75	bp
200bp	107,347	(698 )	(0.65 )	14.98	62	bp
100bp	108,056	11	0.01	14.71	35	bp
Static	108,045	-	-	14.36	0	bp
(100)bp	103,675	(4,370 )	(4.05 )	13.44	(92 )	bp

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The previous tables indicate that at June 30, 2018 and December 31, 2017 the Company would expect a decrease in its EVE in the event of a sudden and sustained 200 or 300 basis point increase in prevailing interest rates and in the event of a sudden and sustained 100 basis point decrease in prevailing interest rates. Alternatively, at June 30, 2018 and December 31, 2017, the Company would expect an increase in its EVE in the event of a sudden and sustained 100 basis point increase in prevailing interest rates.

**PART I – ITEM 3**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES**

**ABOUT MARKET RISK**

**FIRST CAPITAL, INC.**

The models are driven by expected behavior in various interest rate scenarios and many factors besides market interest rates affect the Company's net interest income and EVE. For this reason, the Company models many different combinations of interest rates and balance sheet assumptions to understand its overall sensitivity to market interest rate changes. Therefore, as with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables and it is recognized that the model outputs are not guarantees of actual results. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, 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 may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in the modeling scenarios.

**PART I - ITEM 4**

**CONTROLS AND PROCEDURES**

**FIRST CAPITAL, INC.**

**Controls and Procedures**

The Company's management, including the Company's principal executive officer and principal financial officer, has evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the

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Exchange Act with the SEC (1) is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

There have been no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II

**OTHER INFORMATION**

FIRST CAPITAL, INC.

**Item 1.**

**Legal Proceedings**

None.

**Item 1A.**

**Risk Factors**

There have been no material changes to the risk factors previously disclosed in the “Risk Factors” section of the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

**Item 2.**

**Unregistered Sales of Equity Securities and Use of Proceeds**

**Issuer Purchases of Equity Securities**

On August 19, 2008, the board of directors authorized the repurchase of up to 240,467 shares of the Company’s outstanding common stock. The stock repurchase program will expire upon the purchase of the maximum number of shares authorized under the program, unless the board of directors terminates the program earlier. There were two shares purchased under the stock repurchase program during the quarter ended June 30, 2018. The maximum number of shares that may yet be purchased under the plan is 143,030.

**Item 3.**

**Defaults upon Senior Securities**

Not applicable.

**Item 4.**

**Mine Safety Disclosures**

Not applicable.

**Item 5.**

**Other Information**

None.

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PART II

OTHER INFORMATION

FIRST CAPITAL, INC.

**Item Exhibits**  
**6.**

3.1 Articles of Incorporation of First Capital, Inc. (1)

3.2 Fifth Amended and Restated Bylaws of First Capital, Inc. (2)

11.0 Statement Re: Computation of Per Share Earnings (incorporated by reference to Note 5 of the Unaudited Consolidated Financial Statements contained herein)

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer

32.2 Section 1350 Certification of Chief Financial Officer

101.0 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statement of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to the Consolidated Financial Statements.

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(1) Incorporated by reference to Exhibit 3.1 filed with the Registration Statement on Form SB-2 on September 16, 1998, and any amendments thereto, Registration No. 333-63515, as amended by that Amendment to Articles of Incorporation provided as Exhibit 3.1 to the Report on Form 8-K files with the Securities and Exchange Commission on May 19, 2016.

(2) Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on June 18, 2013.

**SIGNATURES**

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

FIRST CAPITAL, INC.

(Registrant)

**Dated August 8, 2018**      **BY: /s/William W. Harrod**  
William W. Harrod  
President and CEO

**Dated August 8, 2018**      **BY: /s/ Michael C. Frederick**  
Michael C. Frederick  
Executive Vice President, CFO and Treasurer