

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
November 12, 2013

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **September 30, 2013**

or

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

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

Commission File Number: **001-34527**

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

**Pennsylvania**

(State or other jurisdiction of incorporation or organization)

**25-1606091**

(IRS Employer Identification No.)

**612 Main Street, Emlenton,  
Pennsylvania**

(Address of principal executive offices)

**16373**

(Zip Code)

**(724) 867-2311**

(Registrant's telephone number)

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

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

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

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

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

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

The number of shares outstanding of the Registrant's common stock was 1,763,158 at November 12, 2013.

**EMCLAIRE FINANCIAL CORP**

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

Consolidated Balance Sheets  
As of September 30, 2013 (Unaudited) and December 31, 2012  
(Dollar amounts in thousands, except per share data)

	September 30, 2013	December 31, 2012
Assets		
Cash and due from banks	\$ 2,184	\$ 2,468
Interest earning deposits with banks	12,452	17,956
Cash and cash equivalents	14,636	20,424
Securities available for sale	125,325	120,206
Loans receivable, net of allowance for loan losses of \$4,787 and \$5,350	347,729	333,801
Federal bank stocks, at cost	3,707	2,885
Bank-owned life insurance	10,319	10,072
Accrued interest receivable	1,607	1,533
Premises and equipment, net	11,369	9,180
Goodwill	3,664	3,664
Core deposit intangible, net	1,022	1,235
Prepaid expenses and other assets	6,822	6,014
<b>Total Assets</b>	<b>\$ 526,200</b>	<b>\$ 509,014</b>
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	\$ 100,389	\$ 98,559
Interest bearing	329,053	333,900
Total deposits	429,442	432,459
Short-term borrowed funds	26,650	-
Long-term borrowed funds	20,000	20,000
Accrued interest payable	305	442
Accrued expenses and other liabilities	5,140	4,388
<b>Total Liabilities</b>	<b>481,537</b>	<b>457,289</b>
Commitments and Contingent Liabilities	-	-
Stockholders' Equity:		
Preferred stock, \$1.00 par value, 3,000,000 shares authorized;		

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Series B, non-cumulative preferred stock, \$5,000 and \$10,000 liquidation value, 5,000 and 10,000 shares issued and outstanding, respectively	5,000	10,000
Common stock, \$1.25 par value, 12,000,000 shares authorized; 1,865,175 and 1,861,425 shares issued; 1,763,158 and 1,759,408 shares outstanding	2,331	2,327
Additional paid-in capital	19,418	19,270
Treasury stock, at cost; 102,017 shares	(2,114)	(2,114)
Retained earnings	23,129	21,672
Accumulated other comprehensive income (loss)	(3,101)	570
Total Stockholders' Equity	44,663	51,725
Total Liabilities and Stockholders' Equity	\$ 526,200	\$ 509,014

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

Consolidated Statements of Net Income (Unaudited)  
For the three and nine months ended September 30, 2013 and 2012  
(Dollar amounts in thousands, except per share data)

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Interest and dividend income:				
Loans receivable, including fees	\$ 4,114	\$ 4,389	\$ 12,411	\$ 12,989
Securities:				
Taxable	440	617	1,328	1,763
Exempt from federal income tax	314	287	875	873
Federal bank stocks	18	15	52	46
Interest earning deposits with banks	12	17	44	68
Total interest and dividend income	4,898	5,325	14,710	15,739
Interest expense:				
Deposits	662	1,008	2,305	3,105
Borrowed funds	198	238	590	707
Total interest expense	860	1,246	2,895	3,812
Net interest income	4,038	4,079	11,815	11,927
Provision for loan losses	143	1,359	438	1,587
Net interest income after provision for loan losses	3,895	2,720	11,377	10,340
Noninterest income:				
Fees and service charges	428	428	1,254	1,159
Commissions on financial services	48	158	187	383
Title premiums	6	13	55	46
Net gain on sales of available for sale securities	107	390	291	1,352
Net gain on sales of loans	9	-	9	-
Earnings on bank-owned life insurance	97	81	290	205
Other	307	303	877	868
Total noninterest income	1,002	1,373	2,963	4,013
Noninterest expense:				
Compensation and employee benefits	1,847	1,678	5,684	5,488
Premises and equipment	516	509	1,586	1,527
Intangible asset amortization	67	86	213	272
Professional fees	158	135	513	510
Federal deposit insurance	99	92	307	282
Other	856	857	2,447	2,476
Total noninterest expense	3,543	3,357	10,750	10,555

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Income before provision for income taxes	1,354	736	3,590	3,798
Provision for income taxes	272	67	711	835
Net income	1,082	669	2,879	2,963
Preferred stock dividends	115	118	365	368
Net income available to common stockholders	\$ 967	\$ 551	\$ 2,514	\$ 2,595
Basic earnings per common share	\$ 0.55	\$ 0.31	\$ 1.43	\$ 1.48
Diluted earnings per common share	0.54	0.31	1.42	1.48
Average common shares outstanding	1,762,810	1,751,908	1,761,972	1,751,908

See accompanying notes to consolidated financial statements.



**Emclaire Financial Corp**  
 Consolidated Statements of Comprehensive Income (Loss) (Unaudited)  
 For the three and nine months ended September 30, 2013 and 2012  
 (Dollar amounts in thousands)

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Net income	\$ 1,082	\$ 669	\$ 2,879	\$ 2,963
Other comprehensive income (loss)				
Unrealized gains (losses) on securities:				
Unrealized holding gain (loss) arising during the period	(800)	444	(5,271)	887
Reclassification adjustment for gains included in net income	(107)	(390)	(291)	(1,352)
Tax effect	(907)	54	(5,562)	(465)
	308	(18)	1,891	158
Net of tax	(599)	36	(3,671)	(307)
Comprehensive income (loss)	\$ 483	\$ 705	\$ (792)	\$ 2,656

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
For the nine months ended September 30, 2013 and 2012  
(Dollar amounts in thousands)

	For the nine months ended September 30,	
	2013	2012
Cash flows from operating activities		
Net income	\$ 2,879	\$ 2,963
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	503	505
Provision for loan losses	438	1,587
Amortization of premiums, net	152	92
Amortization of intangible assets and mortgage servicing rights	213	277
Realized gains on sales of available for sale securities, net	(291)	(1,352)
Net gains on sales of loans	(9)	-
Net losses on foreclosed real estate	5	21
Originations of loans sold	(202)	-
Proceeds from the sale of loans	211	-
Restricted stock and stock option compensation	133	92
Increase in bank-owned life insurance, net	(247)	(180)
Increase in accrued interest receivable	(74)	(106)
(Increase) decrease in prepaid expenses and other assets	1,159	(643)
Decrease in accrued interest payable	(137)	(25)
Increase (decrease) in accrued expenses and other liabilities	644	(13)
Net cash provided by operating activities	5,377	3,218
Cash flows from investing activities		
Loan originations and principal collections, net	(14,733)	(20,975)
Available for sale securities:		
Sales	21,015	11,639
Maturities, repayments and calls	28,767	78,146
Purchases	(60,116)	(109,243)
(Purchase) redemption of federal bank stocks	(822)	493
Proceeds from the sale of foreclosed real estate	167	271
Write-down of foreclosed real estate	19	-
Purchases of premises and equipment	(2,692)	(431)
Purchase of bank-owned life insurance	-	(4,000)
Net cash used in investing activities	(28,395)	(44,100)
Cash flows from financing activities		
Net increase (decrease) in deposits	(3,017)	37,029
Net change in short-term borrowings	26,650	-
Proceeds from exercise of stock options, including tax benefit	20	-
Dividends paid	(1,423)	(1,313)
Redemption of preferred stock (Series B)	(5,000)	-
Net cash provided by financing activities	17,230	35,716

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Decrease in cash and cash equivalents	(5,788)	(5,166)
Cash and cash equivalents at beginning of period	20,424	28,193
Cash and cash equivalents at end of period	\$ 14,636	\$ 23,027
Supplemental information:		
Interest paid	\$ 3,032	\$ 3,837
Income taxes paid	140	1,465
Supplemental noncash disclosure:		
Transfers from loans to foreclosed real estate	159	288

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)  
For the three and nine months ended September 30, 2013 and 2012  
(Dollar amounts in thousands, except per share data)

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Balance at beginning of period	\$ 49,613	\$ 51,862	\$ 51,725	\$ 50,730
Net income	1,082	669	2,879	2,963
Other comprehensive income (loss)	(599)	36	(3,671)	(307)
Stock compensation expense	34	31	133	92
Dividends declared on preferred stock	(115)	(118)	(365)	(368)
Dividends declared on common stock	(352)	(315)	(1,058)	(945)
Exercise of stock options, including tax benefit	-	-	20	-
Redemption of preferred stock (5,000 shares, Series B)	(5,000)	-	(5,000)	-
Balance at end of period	\$ 44,663	\$ 52,165	\$ 44,663	\$ 52,165
Common cash dividend per share	\$ 0.20	\$ 0.18	\$ 0.60	\$ 0.54

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

Notes to Consolidated Financial Statements (Unaudited)

**1. Nature of Operations and Basis of Presentation**

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

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

The accompanying unaudited consolidated financial statements for the interim periods include all adjustments, consisting of normal recurring accruals, which are necessary, in the opinion of management, to fairly reflect the Corporation's consolidated financial position and results of operations. Additionally, these consolidated financial statements for the interim periods have been prepared in accordance with instructions for the Securities and Exchange Commission's (SEC's) Form 10-Q and Article 10 of Regulation S-X and therefore do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). For further information, refer to the audited consolidated financial statements and footnotes thereto for the year ended December 31, 2012, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC.

The balance sheet at December 31, 2012 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements.

The preparation of financial statements, in conformity with GAAP, requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, goodwill, real estate owned, the valuation of deferred tax assets and other-than-temporary impairment charges on securities. The results of operations for interim quarterly or year-to-date periods are not necessarily indicative of the results that may be expected for the entire year or any other period. Certain amounts previously reported may have been reclassified to conform to the current year's financial statement presentation.

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

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$10.0 million, pursuant to the U.S. Treasury's SBLF program. On September 17, 2013, with the approval of the Corporation's primary federal banking regulator, the Corporation redeemed 5,000 shares, or 50%, of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of \$5.0 million, plus accrued but unpaid dividends. Following this redemption, the Treasury holds 5,000 shares of the Series B preferred Stock, representing a remaining liquidation value of \$5.0 million.

The Series B Preferred Stock is entitled to receive non-cumulative dividends payable quarterly on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate liquidation amount, was initially set at 5% per annum based upon the current level of Qualified Small Business Lending (QSBL) by the Bank. The dividend rate in subsequent periods is based upon the percentage change in qualified lending between each dividend period and the baseline QSBL level established at the time the Agreement was entered into. Such dividend rate varies from 1% to 5% per annum for the first two and one-half years through the quarter ending December 31, 2013. For the two year period beginning with the quarter ending March 31, 2014, the dividend rate will be fixed at a rate of 1% to 7% per annum. If the Series B Preferred Stock remains outstanding for more than four-and-one-half years, beginning with the quarter ending March 31, 2016, the dividend rate will be fixed at 9%. The dividend rate was 5.0% and 4.72%, respectively, for the quarters ended September 30, 2013 and 2012. For the two-year period beginning with the quarter ended March 31, 2014, the dividend rate will be fixed at 2.0%. Such dividends are not cumulative, but the Corporation may only declare and pay dividends on its common stock (or any other equity securities junior to the Series B Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series B Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities.

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

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

## **3. Earnings per Common Share**

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

**3. Earnings per Common Share (continued)**

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

(Dollar amounts in thousands, except for per share amounts)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Earnings per common share - basic				
Net income	\$ 1,082	\$ 669	\$ 2,879	\$ 2,963
Less: Preferred stock dividends	115	118	365	368
Net income available to common stockholders	\$ 967	\$ 551	\$ 2,514	\$ 2,595
Average common shares outstanding	1,762,810	1,751,908	1,761,972	1,751,908
Basic earnings per common share	\$ 0.55	\$ 0.31	\$ 1.43	\$ 1.48
Earnings per common share - diluted				
Net income available to common stockholders	\$ 967	\$ 551	\$ 2,514	\$ 2,595
Average common shares outstanding	1,762,810	1,751,908	1,761,972	1,751,908
Add: Dilutive effects of assumed exercises of restricted stock and stock options	13,616	-	12,777	-
Average shares and dilutive potential common shares	1,776,426	1,751,908	1,774,749	1,751,908
Diluted earnings per common share	\$ 0.54	\$ 0.31	\$ 1.42	\$ 1.48
Stock options and restricted stock awards not considered in computing diluted earnings per share because they were antidilutive	67,000	84,000	67,000	84,000

**4. Securities**

The following table summarizes the Corporation's securities as of September 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale:				
September 30, 2013:				
U.S. Treasury and federal agency	\$ 4,465	\$ -	\$ (217)	\$ 4,248
U.S. government sponsored entities and agencies	23,636	-	(592)	23,044
Mortgage-backed securities: residential	12,373	486	-	12,859
Collateralized mortgage obligations: residential	44,403	-	(1,851)	42,552
State and political subdivisions	39,820	962	(847)	39,935
Corporate debt securities	250	-	(10)	240
Equity securities	2,356	103	(12)	2,447
	\$ 127,303	\$ 1,551	\$ (3,529)	\$ 125,325
December 31, 2012:				
U.S. Treasury and federal agency	\$ 3,959	\$ 8	\$ -	\$ 3,967
U.S. government sponsored entities and agencies	28,030	132	-	28,162
Mortgage-backed securities: residential	21,137	1,587	-	22,724
Collateralized mortgage obligations: residential	22,508	47	(80)	22,475

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State and political subdivisions	34,904	1,862	(1)	36,765
Corporate debt securities	3,728	34	(1)	3,761
Equity securities	2,356	4	(8)	2,352
	\$ 116,622	\$ 3,674	\$ (90)	\$ 120,206

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**4. Securities (continued)**

The following table summarizes scheduled maturities of the Corporation's debt securities as of September 30, 2013. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

(Dollar amounts in thousands)	Available for sale Amortized Cost	Fair Value
Due in one year or less	\$ 1,001	\$ 1,014
Due after one year through five years	19,688	19,609
Due after five through ten years	42,394	42,056
Due after ten years	5,088	4,788
Mortgage-backed securities: residential	12,373	12,859
Collateralized mortgage obligations: residential	44,403	42,552
	\$ 124,947	\$ 122,878

Information pertaining to securities with gross unrealized losses at September 30, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

(Dollar amounts in thousands)	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2013:						
U.S. Treasury and federal agency	\$ 4,248	\$ (217)	\$ -	\$ -	\$ 4,248	\$ (217)
U.S. government sponsored entities and agencies	23,044	(592)	-	-	23,044	(592)
Collateralized mortgage obligations: residential	42,552	(1,851)	-	-	42,552	(1,851)
State and political subdivisions	15,286	(847)	-	-	15,286	(847)
Corporate debt securities	241	(10)	-	-	241	(10)
Equity securities	954	(12)	-	-	954	(12)
	\$ 86,325	\$ (3,529)	\$ -	\$ -	\$ 86,325	\$ (3,529)
December 31, 2012:						
Collateralized mortgage obligations: residential	\$ 10,698	\$ (80)	\$ -	\$ -	\$ 10,698	\$ (80)
State and political subdivisions	521	(1)	-	-	521	(1)
Corporate debt securities	500	(1)	-	-	500	(1)
Equity securities	493	(8)	-	-	493	(8)
	\$ 12,212	\$ (90)	\$ -	\$ -	\$ 12,212	\$ (90)

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

(Dollar amounts in thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012

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Proceeds	\$	17,701	\$	6,043	\$	21,015	\$	11,639
Gains		107		390		291		1,352
Tax provision related to gains		36		133		99		460

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#### 4. Securities (continued)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before recovery of its amortized cost basis. If the Corporation intends to sell an impaired security, or if it is more likely than not the Corporation will be required to sell the security before its anticipated recovery, the Corporation records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost. Otherwise, only the credit portion of the estimated loss on debt securities is recognized in earnings, with the other portion of the loss recognized in other comprehensive income. For equity securities determined to be other-than-temporarily impaired, the entire amount of impairment is recognized through earnings.

There were two equity securities in an unrealized loss position as of September 30, 2013. These securities have been in an unrealized loss position for less than 12 months and were valued at 94% and 99% of their cost basis, respectively. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment securities are in an unrealized loss position as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability and capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell these securities before the recovery of their amortized cost basis, the Corporation does not consider the equity securities with an unrealized loss as of September 30, 2013 to be other-than-temporarily impaired.

There were 119 debt securities in an unrealized loss position as of September 30, 2013, all of which were in an unrealized loss position for less than 12 months. Of these securities, eight were U.S. Treasury securities, 17 were U.S. agency securities, 29 were government-backed collateralized mortgage obligations, 64 were state and political subdivision securities and one was a corporate debt security. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the failure to collect contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of September 30, 2013 to be other-than-temporarily impaired.

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

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

(Dollar amounts in thousands)	September 30, 2013	December 31, 2012
Mortgage loans on real estate:		
Residential first mortgages	\$ 99,412	\$ 97,246
Home equity loans and lines of credit	87,763	85,615
Commercial real estate	103,079	98,823
	290,254	281,684
Other loans:		
Commercial business	52,309	45,581
Consumer	9,953	11,886
	62,262	57,467
Total loans, gross	352,516	339,151
Less allowance for loan losses	4,787	5,350
Total loans, net	\$ 347,729	\$ 333,801

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of September 30, 2013:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the three months ended September 30, 2013		
	As of September 30, 2013			Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
	Unpaid Principal Balance	Recorded Investment	Related Allowance			
Residential first mortgages	\$ 82	\$ 82	\$ 21	\$ 81	\$ 2	\$ 2
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,633	2,692	209	2,708	2	2
Commercial business	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$ 3,715	\$ 2,774	\$ 230	\$ 2,789	\$ 4	\$ 4

	For the nine months ended September 30, 2013			Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
	Unpaid Principal Balance	Recorded Investment	Related Allowance			
Residential first mortgages				\$ 41	\$ 4	\$ 4
Home equity and lines of credit				-	-	-
Commercial real estate				3,372	11	11
Commercial business				-	-	-
Consumer				-	-	-
Total				\$ 3,413	\$ 15	\$ 15

	Impaired Loans with No Specific Allowance			For the three months ended September 30, 2013		
	As of September 30, 2013			Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
	Unpaid Principal Balance	Recorded Investment	Related Allowance			
Residential first mortgages	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	1,012	613	637	637	2	2
Commercial business	346	346	351	351	-	-
Consumer	1,348	1,348	1,348	1,348	-	-
Total	\$ 2,706	\$ 2,307	\$ 2,336	\$ 2,336	\$ 2	\$ 2

For the nine months ended September 30, 2013

	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-
Commercial real estate	561	4	4
Commercial business	359	-	-
Consumer	1,484	-	-
Total	\$ 2,404	\$ 4	\$ 4

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2012:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the year ended		
	As of December 31, 2012			December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	4,242	4,068	1,448	2,075	186	16
Commercial business	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$ 4,242	\$ 4,068	\$ 1,448	\$ 2,075	\$ 186	\$ 16

	Impaired Loans with No Specific Allowance			For the year ended		
	As of December 31, 2012			December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	730	505	-	690	12	12
Commercial business	394	369	-	368	5	5
Consumer	1,650	1,650	-	1,774	-	-
Total	\$ 2,774	\$ 2,524	\$ -	\$ 2,832	\$ 17	\$ 17

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

**Troubled debt restructurings (TDR).** The Corporation has certain loans that have been modified in order to maximize collection of loan balances. If, for economic or legal reasons related to the customer's financial difficulties, management grants a concession compared to the original terms and conditions of the loan that it would not have otherwise considered, the modified loan is classified as a TDR. Concessions related to TDRs generally do not include forgiveness of principal balances. The Corporation generally does not extend additional credit to borrowers with loans classified as TDRs.

At September 30, 2013 and December 31, 2012, the Corporation had \$2.1 million and \$2.3 million, respectively, of loans classified as TDRs, which are included in impaired loans above. At September 30, 2013 and December 31, 2012, the Corporation had \$56,000 and \$36,000, respectively, of the allowance for loan losses allocated to these

specific loans. At September 30, 2012, the Corporation had \$791,000 of loans classified as TDRs with \$36,000 of the allowance for loan losses allocated to these specific loans.

During the nine month period ended September 30, 2013, the Corporation modified a residential mortgage loan with a pre- and post-modification recorded investment of \$83,000 as a TDR due to financial difficulties experienced by the borrower. The modification included a reduction in the interest rate from 6.75% to 4.00% and a 65 month extension of the original term. At September 30, 2013, the Corporation had \$21,000 of the allowance for loan losses allocated to this specific loan. During the nine month period ended September 30, 2012, the Corporation did not modify any additional loans as TDRs.



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

During the nine month periods ended September 30, 2013 and 2012, the Corporation did not have any loans which were modified as TDRs for which there was a payment default within twelve months following the modification.

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

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

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

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

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

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

Management uses the following definitions for risk ratings:

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

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

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

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

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

The following table presents the classes of the loan portfolio summarized by the aggregate pass and the criticized categories of special mention, substandard and doubtful within the Corporation's internal risk rating system as of September 30, 2013 and December 31, 2012:

*(Dollar amounts in thousands)*

	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2013:						
Residential first mortgages	\$ 98,906	\$ -	\$ -	\$ 506	\$ -	\$ 99,412
Home equity and lines of credit	87,613	-	-	150	-	87,763
Commercial real estate	-	95,378	266	7,435	-	103,079
Commercial business	-	49,097	682	2,530	-	52,309
Consumer	8,605	-	-	1,348	-	9,953
Total	\$ 195,124	\$ 144,475	\$ 948	\$ 11,969	\$ -	\$ 352,516
December 31, 2012:						
Residential first mortgages	\$ 96,713	\$ -	\$ -	\$ 533	\$ -	\$ 97,246
Home equity and lines of credit	85,443	-	-	172	-	85,615
Commercial real estate	-	88,944	1,658	6,870	1,351	98,823
Commercial business	-	42,417	2,157	1,007	-	45,581
Consumer	10,236	-	-	1,650	-	11,886
Total	\$ 192,392	\$ 131,361	\$ 3,815	\$ 10,232	\$ 1,351	\$ 339,151

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of September 30, 2013 and December 31, 2012:

*(Dollar amounts in thousands)*

	Performing Accruing Loans Not Past Due	Accruing 30-59 Days Past Due	Accruing 60-89 Days Past Due	Nonperforming Accruing 90 Days + Past Due	Nonaccrual	Total Loans
September 30, 2013:						
Residential first mortgages	\$ 96,594	\$ 1,886	\$ 426	\$ 100	\$ 406	\$ 99,412
Home equity and lines of credit	87,075	525	13	-	150	87,763
Commercial real estate	99,915	185	19	-	2,960	103,079
Commercial business	51,909	54	-	-	346	52,309
Consumer	8,581	22	2	-	1,348	9,953
Total loans	\$ 344,074	\$ 2,672	\$ 460	\$ 100	\$ 5,210	\$ 352,516
December 31, 2012:						
Residential first mortgages	\$ 95,001	\$ 1,272	\$ 440	\$ -	\$ 533	\$ 97,246

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Home equity and lines of credit	84,592	669	157	-	197	85,615
Commercial real estate	94,485	50	49	21	4,218	98,823
Commercial business	44,915	297	-	-	369	45,581
Consumer	10,172	41	23	-	1,650	11,886
Total loans	\$ 329,165	\$ 2,329	\$ 669	\$ 21	\$ 6,967	\$ 339,151

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

The following table presents the Corporation's nonaccrual loans by aging category as of September 30, 2013 and December 31, 2012:

*(Dollar amounts in thousands)*

	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total Loans
September 30, 2013:					
Residential first mortgages	\$ 171	\$ -	\$ -	\$ 235	\$ 406
Home equity and lines of credit	-	-	-	150	150
Commercial real estate	428	2,228	-	304	2,960
Commercial business	67	-	-	279	346
Consumer	1,348	-	-	-	1,348
Total loans	\$ 2,014	\$ 2,228	\$ -	\$ 968	\$ 5,210
December 31, 2012:					
Residential first mortgages	\$ -	\$ -	\$ -	\$ 533	\$ 533
Home equity and lines of credit	-	25	-	172	197
Commercial real estate	469	3,386	10	353	4,218
Commercial business	78	-	-	291	369
Consumer	1,650	-	-	-	1,650
Total loans	\$ 2,197	\$ 3,411	\$ 10	\$ 1,349	\$ 6,967

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

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

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

The following table details activity in the ALL and the recorded investment by portfolio segment based on impairment method:

*(Dollar amounts in thousands)*

	Residential Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
Three months ended September 30, 2013:						
Allowance for loan losses:						
Beginning Balance	\$ 772	\$ 621	\$ 2,547	\$ 677	\$ 53	\$ 4,670
Charge-offs	(9)	(8)	-	-	(16)	(33)
Recoveries	-	-	2	-	5	7
Provision	87	1	(110)	154	11	143
Ending Balance	\$ 850	\$ 614	\$ 2,439	\$ 831	\$ 53	\$ 4,787
Nine months ended September 30, 2013:						
Allowance for loan losses:						
Beginning Balance	\$ 828	\$ 730	\$ 3,090	\$ 636	\$ 66	\$ 5,350
Charge-offs	(26)	(8)	(941)	-	(72)	(1,047)
Recoveries	1	-	6	-	39	46
Provision	47	(108)	284	195	20	438
Ending Balance	\$ 850	\$ 614	\$ 2,439	\$ 831	\$ 53	\$ 4,787
At September 30, 2013:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	21	-	209	-	-	230
Collectively evaluated for impairment	829	614	2,230	831	53	4,557
Total loans:						
Individually evaluated for impairment	82	-	3,305	346	1,348	5,081
Collectively evaluated for impairment	99,330	87,763	99,774	51,963	8,605	347,435
At December 31, 2012:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	-	-	1,448	-	-	1,448
Collectively evaluated for impairment	828	730	1,642	636	66	3,902
Total loans:						
Individually evaluated for impairment	-	-	4,573	369	1,650	6,592
Collectively evaluated for impairment	97,246	85,615	94,250	45,212	10,236	332,559
Three months ended September 30, 2012:						
Allowance for loan losses:						
Beginning Balance	\$ 852	\$ 468	\$ 1,835	\$ 496	\$ 64	\$ 3,715
Charge-offs	(13)	-	-	(5)	(41)	(59)
Recoveries	1	-	1	-	6	8
Provision	(26)	104	1,229	12	40	1,359
Ending Balance	\$ 814	\$ 572	\$ 3,065	\$ 503	\$ 69	\$ 5,023

Nine months ended September 30, 2012:

Allowance for loan losses:

Beginning Balance	\$ 832	\$ 320	\$ 1,737	\$ 590	\$ 57	\$ 3,536
Charge-offs	(78)	(40)	(36)	(14)	(79)	(247)
Recoveries	84	27	5	15	16	147
Provision	(24)	265	1,359	(88)	75	1,587
Ending Balance	\$ 814	\$ 572	\$ 3,065	\$ 503	\$ 69	\$ 5,023

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

## 6. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of September 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)	September 30, 2013		December 31, 2012	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$ 3,664	\$ -	\$ 3,664	\$ -
Core deposit intangibles	4,027	3,005	4,027	2,792
Total	\$ 7,691	\$ 3,005	\$ 7,691	\$ 2,792

Goodwill resulted from three previous branch acquisitions. Goodwill represents the excess of the total purchase price paid for the branch acquisitions over the fair value of the assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. No goodwill impairment charges were recorded during 2012 or in the first nine months of 2013. The core deposit intangible asset is amortized using the double declining balance method over a weighted average estimated life of nine years and is not estimated to have a significant residual value. During the three and nine month periods ending September 30, 2013, the Corporation recorded intangible amortization expense totaling \$67,000 and \$213,000, respectively, compared to \$86,000 and \$272,000, respectively, for the same periods in the prior year.

## 7. Stock Compensation Plans

The Corporation's 2007 Stock Incentive Plan and Trust (the Plan), which is shareholder approved, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock. Incentive stock options, non-incentive or compensatory stock options and share awards may be granted under the Plan. The exercise price of each option shall at least equal the market price of a share of common stock on the date of grant and have a contractual term of ten years. Options shall vest and become exercisable at the rate, to the extent and subject to such limitations as may be specified by the Corporation. Compensation cost related to share-based payment transactions must be recognized in the financial statements with measurement based upon the fair value of the equity instruments issued.

A summary of option activity under the Plan as of September 30, 2013, and changes during the period then ended is presented below:

	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted-Average Remaining Term (in years)
Outstanding as of January 1, 2013	86,250	\$ 24.79	\$ -	4.9
Granted	-	-	-	-
Exercised	(1,500)	13.50	-	-
Forfeited	(5,500)	25.28	-	-
Outstanding as of September 30, 2013	79,250	\$ 24.97	\$ 80,908	4.1
Exercisable as of September 30, 2013	76,500	\$ 25.27	\$ 55,325	3.9





**7. Stock Compensation Plans (continued)**

A summary of the status of the Corporation's nonvested option shares as of September 30, 2013, and changes during the period then ended is presented below:

	Options	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2013	2,750	\$ 2.43
Granted	-	-
Vested	-	-
Forfeited	-	-
Nonvested as of September 30, 2013	2,750	\$ 2.43

A summary of the status of the Corporation's nonvested restricted stock awards as of September 30, 2013, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2013	25,650	\$ 17.30
Granted	-	-
Vested	(2,250)	14.69
Forfeited	-	-
Nonvested as of September 30, 2013	23,400	\$ 17.55

For the three and nine month periods ended September 30, 2013, the Corporation recognized \$34,000 and \$133,000, respectively, in stock compensation expense, compared to \$31,000 and \$92,000, respectively, for the same periods in 2012. As of September 30, 2013, there was \$190,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next 2.2 years. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.

**8. Employee Benefit Plans**

The Corporation provides pension benefits for eligible employees through a defined benefit pension plan. Substantially all employees participate in the retirement plan on a non-contributory basis, and are fully vested after three years of service. Effective January 1, 2009, the plan was closed to new participants.

The Corporation provided the requisite notice to plan participants on March 12, 2013 of the determination to freeze the plan (curtailment). While the freeze was not effective until April 30, 2013, management determined that participants would not satisfy, within the provisions of the plan, 2013 eligibility requirements based on minimum hours worked for 2013. Therefore, employees ceased to earn benefits as of January 1, 2013. This amendment to the plan will not affect benefits earned by the participant prior to the date of the freeze.

**9. Fair Value**

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

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

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

## 9. Fair Value (continued)

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

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

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

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

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

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

*Impaired loans* At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of September 30, 2013, the fair value of impaired loans consists of loan balances of \$2.8 million, net of a valuation allowance of \$230,000, compared to loan balances of \$4.1 million, net of a valuation allowance of \$1.4 million, at December 31, 2012. There was no additional provision for loan losses and \$21,000 of additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2013, respectively. There was \$1.4 million and \$1.5 million of additional provision for loan losses recorded for impaired loans during the three and nine month periods ended September 30, 2012.

**9. Fair Value (continued)**

*Other Real estate owned (OREO)* Assets acquired through or instead of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Management's ongoing review of appraisal information may result in additional discounts or adjustments to the valuation based upon more recent market sales activity or more current appraisal information derived from properties of similar type and/or locale. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. As of September 30, 2013, OREO measured at fair value less costs to sell had a net carrying amount of \$35,000, which was made up of the outstanding balance of \$50,000 and write-downs of \$15,000, compared to a net carrying amount of \$45,000, which was made up of the outstanding balance of \$50,000 and write-downs of \$5,000 at December 31, 2012.

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

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

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

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

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

**9. Fair Value (continued)**

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

(Dollar amounts in thousands)		(Level 1)	(Level 2)	(Level 3)
Description	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
September 30, 2013:				
U.S. Treasury and federal agency	\$ 4,248	\$ 4,248	\$ -	\$ -
U.S. government sponsored entities and agencies	23,044	-	23,044	-
Mortgage-backed securities: residential	12,859	-	12,859	-
Collateralized mortgage obligations: residential	42,552	-	42,552	-
State and political subdivision	39,935	-	39,935	-
Corporate debt securities	240	-	240	-
Equity securities	2,447	1,795	-	652
	\$ 125,325	\$ 6,043	\$ 118,630	\$ 652
December 31, 2012:				
U.S. Treasury and federal agency	\$ 3,967	\$ 3,967	\$ -	\$ -
U.S. government sponsored entities and agencies	28,162	-	28,162	-
Mortgage-backed securities: residential	22,724	-	22,724	-
Collateralized mortgage obligations: residential	22,475	-	22,475	-
State and political subdivision	36,765	-	36,765	-
Corporate debt securities	3,761	-	3,761	-
Equity securities	2,352	1,699	-	653
	\$ 120,206	\$ 5,666	\$ 113,887	\$ 653

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and nine month periods ended September 30, 2013, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the three and nine month periods ended September 30, 2013 and 2012:

(Dollar amounts in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Balance at the beginning of the period	\$ 653	\$ -	\$ 653	\$ -
Total gains or losses (realized/unrealized):	-	-	-	-
Included in earnings	-	-	-	-
Included in other comprehensive income	(1)	-	(1)	-
Issuances	-	-	-	-
Transfers in and/or out of Level 3	-	653	-	653
Balance at the end of the period	\$ 652	\$ 653	\$ 652	\$ 653



**9. Fair Value (continued)**

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

(Dollar amounts in thousands)		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
September 30, 2013:				
Impaired commercial real estate loans	\$ 2,483	\$ -	\$ -	\$ 2,483
Other residential real estate owned	35	-	-	35
	\$ 2,518	\$ -	\$ -	\$ 2,518
December 31, 2012:				
Impaired commercial real estate loans	\$ 2,620	\$ -	\$ -	\$ 2,620
Other residential real estate owned	45	-	-	45
	\$ 2,665	\$ -	\$ -	\$ 2,665

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

(Dollar amounts in thousands)	Valuation Techniques(s)	Unobservable Input (s)	Range
September 30, 2013:			
Impaired commercial real estate loans	\$2,483	Sales comparison approach/ Contractual provision of USDA loan	Adjustment for differences between comparable sales 0% - 10%
Other residential real estate owned	35	Sales comparison approach	Adjustment for differences between comparable sales 10%
December 31, 2012:			
Impaired commercial real estate loans	2,620	Sales comparison approach/ Contractual provision of USDA loan	Adjustment for differences between comparable sales 10% - 25%
Other residential real estate owned	45	Sales comparison approach	Adjustment for differences between comparable sales 10%

The two tables above exclude a \$61,000 impaired residential mortgage loan classified as a troubled debt restructure which was measured at fair value using a discounted cash flow methodology at September 30, 2013.

Included in impaired commercial real estate loans is a loan guaranteed by the United States Department of Agriculture (USDA) with balances of \$350,000 and \$354,000, respectively, as of September 30, 2013 and December 31, 2012. The guarantee covers 90% of the principal balance outstanding. In determining the fair value of this loan, the Corporation considered the contractual provisions of the loan and did not rely on the fair value of the underlying



collateral. As such, the Corporation applied a 10% discount to the loan which represents the portion of the loan at risk. The weighted average discount on impaired loans as of September 30, 2013 and December 31, 2012 was 2% and 11%, respectively.

**9. Fair Value (continued)**

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of September 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Measurements using:			
		Total	Level 1	Level 2	Level 3
September 30, 2013:					
Financial Assets:					
Cash and cash equivalents	\$ 14,636	\$ 14,636	\$ 14,636	\$ -	\$ -
Securities available for sale	125,325	125,325	6,043	118,630	652
Loans, net	347,729	352,256	-	-	352,256
Federal bank stock	3,707	N/A	N/A	N/A	N/A
Accrued interest receivable	1,607	1,607	33	484	1,090
	493,004	493,824	20,712	119,114	353,998
Financial Liabilities:					
Deposits	429,442	431,120	321,797	109,323	-
Borrowed funds	46,650	47,834	-	47,834	-
Accrued interest payable	305	305	4	301	-
	476,397	479,259	321,801	157,458	-
December 31, 2012:					
Financial Assets:					
Cash and cash equivalents	\$ 20,424	\$ 20,424	\$ 20,424	\$ -	\$ -
Securities available for sale	120,206	120,206	5,666	113,887	653
Loans, net	333,801	340,840	-	-	340,840
Federal bank stock	2,885	N/A	N/A	N/A	N/A
Accrued interest receivable	1,533	1,533	23	383	1,127
	478,849	483,003	26,113	114,270	342,620
Financial Liabilities:					
Deposits	432,459	436,279	300,805	135,474	-
FHLB advances	20,000	22,613	-	22,613	-
Accrued interest payable	442	442	55	387	-
	452,901	459,334	300,860	158,474	-

**10. Accumulated Other Comprehensive Income**

The following tables summarize the changes within each classification of accumulated other comprehensive income, net of tax, for the three and nine months ended September 30, 2013 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income at July 1, 2013	\$ (707)	\$ (1,795)	\$ (2,502)
Other comprehensive income before reclassification	(528)	-	(528)
Amounts reclassified from accumulated other comprehensive income	(71)	-	(71)
Net current period other comprehensive loss	(599)	-	(599)
Accumulated Other Comprehensive Income at September 30, 2013	\$ (1,306)	\$ (1,795)	\$ (3,101)

(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the three months ended September 30, 2013	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 107	Gain on sale of securities
	(36)	Tax expense
Total reclassifications for the period	\$ 71	Net of tax

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income at January 1, 2013	\$ 2,365	\$ (1,795)	\$ 570
Other comprehensive income before reclassification	(3,479)	-	(3,479)
Amounts reclassified from accumulated other comprehensive income	(192)	-	(192)
Net current period other comprehensive loss	(3,671)	-	(3,671)
Accumulated Other Comprehensive Income at September 30, 2013	\$ (1,306)	\$ (1,795)	\$ (3,101)

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(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the nine months ended September 30, 2013	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 291	Gain on sale of securities
	(99)	Tax expense
Total reclassifications for the period	\$ 192	Net of tax

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

This section discusses the consolidated financial condition and results of operations of Emclair Financial Corp and its wholly owned subsidiaries, the Bank and the Title Company, for the three and nine months ended September 30, 2013, compared to the same periods in 2012 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 25 of this Form 10-Q.

This Form 10-Q, including the financial statements and related notes, contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, objectives, expected operating results and the assumptions upon which those statements are based. Forward looking statements include without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and are typically identified with words such as "may," "could," "should," "will," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan" or words or phrases of similar meaning. We caution that the forward looking statements are based largely on our expectations and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are, in many instances, beyond our control. Actual results, performances or achievements could differ materially from those contemplated, expressed or implied by the forward looking statements. Therefore, we caution you not to place undue reliance on our forward looking information and statements. Except as required by applicable law or regulation, we will not update the forward looking statements to reflect actual results or changes in factors affecting the forward looking statements.

### **CHANGES IN FINANCIAL CONDITION**

Total assets increased \$17.2 million, or 3.4%, to \$526.2 million at September 30, 2013 from \$509.0 million at December 31, 2012. This increase resulted primarily from increases in loans receivable, securities and premises and equipment of \$13.9 million, \$5.1 million and \$2.2 million, respectively, which was funded by a decrease in cash and due from banks of \$5.8 million and an increase in short-term borrowed funds of \$26.7 million. Management plans to decrease the level of short-term advances over the next 12 months as the bank sources deposits through its new branch offices in Saint Marys, Pennsylvania and Cranberry Township, Pennsylvania. The increase in premises and equipment relates primarily to the purchase of property for the construction of a new branch office in Cranberry Township.

Total liabilities increased \$24.2 million, or 5.3%, to \$481.5 million at September 30, 2013 from \$457.3 million at December 31, 2012, resulting primarily from the aforementioned \$26.7 million increase in short-term borrowed funds as the Corporation utilized short-term advances to fund loan growth which outpaced growth in deposits. Customer deposits decreased \$3.0 million, which consisted of a \$1.8 million, or 1.9%, increase in noninterest bearing deposits and a \$4.8 million, or 1.5%, decrease in interest bearing deposits.

Stockholders' equity decreased \$7.1 million to \$44.7 million at September 30, 2013 from \$51.7 million at December 31, 2012. This resulted from the redemption of \$5.0 million, or 50%, of the \$10.0 million in outstanding preferred shares that had been issued to the United States Department of the Treasury (the Treasury) in August 2011 through the Small Business Lending Fund (SBLF) and a \$3.7 million decrease in accumulated other comprehensive income due to unrealized losses on the Corporation's securities portfolio attributable to the recent rise in long term market interest rates. Book value and tangible book value per common share were \$22.50 and \$19.84, respectively, at September 30, 2013, compared to \$23.72 and \$20.93, respectively, at December 31, 2012.

At September 30, 2013, the Bank was considered "well-capitalized" under regulatory guidelines with a Tier 1 leverage ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.36%, 13.81% and 15.06%, respectively,

compared to 8.92%, 14.96% and 16.21%, respectively, at December 31, 2012. The decrease in the capital ratios relate to the aforementioned decrease in equity from the redemption of \$5.0 million of preferred stock and the 3.4% increase in assets.

## RESULTS OF OPERATIONS

### *Comparison of Results for the Three Months Ended September 30, 2013 and 2012*

**General.** Net income before preferred stock dividends increased \$413,000, or 61.7%, to \$1.1 million for the three months ended September 30, 2013 from \$669,000 for the same period in 2012. This increase was the result of a decrease in the provision for loan losses of \$1.2 million, partially offset by decreases in net interest income and noninterest income of \$41,000 and \$371,000, respectively, and increases in noninterest expense and the provision for income taxes of \$186,000 and \$205,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis decreased \$30,000, or 0.7%, to \$4.2 million for the three months ended September 30, 2013 from \$4.3 million for the three months ended September 30, 2012. This decrease can be attributed to a decrease in tax equivalent interest income of \$416,000, partially offset by a decrease in interest expense of \$386,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$416,000, or 7.5%, to \$5.1 million for the three months ended September 30, 2013 compared to \$5.5 million for the three months ended September 30, 2012. This decrease can be attributed to decreases in interest on loans, securities and interest-earning deposits with banks of \$272,000, \$142,000 and \$5,000, respectively, partially offset by an increase in interest earned on federal bank stocks of \$3,000.

Tax equivalent interest earned on loans receivable decreased \$272,000, or 6.1%, to \$4.2 million for the three months ended September 30, 2013 compared to \$4.5 million for the three months ended September 30, 2012. This decrease resulted from a 48 basis points decline in the average yield on loans to 4.85% for the three months ended September 30, 2013, versus 5.33% for the same period in 2012. This unfavorable yield variance accounted for a \$398,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$9.6 million, or 2.9%, accounting for an increase of \$126,000 in loan interest income. Management's strategy to increase loan production capacity, which includes the expansion of the corporate banking team and the projected entrance into new markets in the coming quarters, is key to overcoming the decrease in loan yields caused by an overall decline in market interest rates.

Tax equivalent interest earned on securities decreased \$142,000, or 13.9%, to \$882,000 for the three months ended September 30, 2013 as compared to \$1.0 million for the three months ended September 30, 2012. This decrease resulted from an 11 basis point decline in the average yield on securities to 2.53% for the three months ended September 30, 2013, versus 2.64% for the same period in 2012, due primarily to the sale of higher-yielding securities. This unfavorable yield variance accounted for a \$39,000 decrease in interest income. Additionally, the average balance of securities decreased \$16.0 million, or 10.4%, accounting for a \$103,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$386,000, or 31.0%, to \$860,000 for the three months ended September 30, 2013 from \$1.2 million for the same period in 2012. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$346,000 and \$40,000, respectively.

Interest expense incurred on deposits decreased \$346,000, or 34.3%, to \$662,000 for the three months ended September 30, 2013 compared to \$1.0 million for the same period in 2012. The average cost of interest-bearing deposits decreased 34 basis points to 0.79% for the three months ended September 30, 2013, compared to 1.13% for the same period in 2012, resulting in a \$286,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during late 2012 and the first nine months of 2013 in the prevailing low interest-rate environment. Additionally, the average balance of interest-bearing deposits decreased \$22.4 million, or 6.3%, to \$332.4 million for the three months ended September 30, 2013, compared to \$354.7 million for the same period in 2012 causing a \$60,000 decrease in interest expense. Average noninterest bearing deposits increased \$3.5

million, or 3.4%, to \$104.8 million from \$101.3 million, facilitating the overall decline in the Corporation's cost of funds.



Interest expense incurred on borrowed funds decreased \$40,000, or 16.8%, to \$198,000 for the three months ended September 30, 2013, compared to \$238,000 for the same period in the prior year. The average cost of borrowed funds decreased 245 basis points to 2.27% for the three months ended September 30, 2013, compared to 4.72% for the same period in 2012, causing a \$160,000 decrease in interest expense. This was the result of the Corporation exchanging and modifying \$15.0 million of the \$20.0 million in outstanding Federal Home Loan Bank (FHLB) advances during the fourth quarter of 2012. The modification reduced the average rate on the \$15.0 million of advances from 4.83% to 0.93%. Prepayment penalties totaling \$2.3 million were cash-settled at the time of modification and are being amortized over five years, the life of the new advances. In addition, short-term borrowings were utilized during the third quarter of 2013 with an average rate of 0.35%. Partially offsetting the favorable rate variance, the average balance of borrowed funds increased \$14.5 million, or 72.4%, to \$34.6 million for the three months ended September 30, 2013, compared to \$20.0 million for the same period in 2012 as the Corporation utilized short-term borrowings, which caused a \$120,000 increase in interest expense. Short-term borrowings at September 30, 2013 included \$24.5 million of FHLB overnight advances with a rate of 0.25% and a \$2.2 million advance on a line of credit with a correspondent bank with a rate of 4.25%.

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

(Dollar amounts in thousands)	Three months ended September 30, 2013			2012		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$ 323,605	\$ 3,946	4.84 %	\$ 311,238	\$ 4,222	5.40 %
Loans, tax exempt	18,567	240	5.12 %	21,333	236	4.40 %
Total loans receivable	342,172	4,186	4.85 %	332,571	4,458	5.33 %
Securities, taxable	94,579	440	1.85 %	117,783	617	2.08 %
Securities, tax exempt	43,822	442	4.00 %	36,620	407	4.42 %
Total securities	138,401	882	2.53 %	154,403	1,024	2.64 %
Interest-earning deposits with banks	9,559	12	0.50 %	17,561	17	0.39 %
Federal bank stocks	3,571	18	2.00 %	3,249	15	1.84 %
Total interest-earning other assets	13,130	30	0.91 %	20,810	32	0.61 %
Total interest-earning assets	493,703	5,098	4.10 %	507,784	5,514	4.32 %
Cash and due from banks	2,076			2,322		
Other noninterest-earning assets	29,890			23,377		
<b>Total Assets</b>	<b>\$ 525,669</b>			<b>\$ 533,483</b>		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 221,695	\$ 94	0.17 %	\$ 217,864	\$ 125	0.23 %
Time deposits	110,697	568	2.03 %	136,882	883	2.57 %
Total interest-bearing deposits	332,392	662	0.79 %	354,746	1,008	1.13 %
Borrowed funds, short-term	14,557	13	0.35 %	43	-	0.00 %
Borrowed funds, long-term	20,000	185	3.67 %	20,000	238	4.73 %
Total borrowed funds	34,557	198	2.27 %	20,043	238	4.72 %
Total interest-bearing liabilities	366,949	860	0.93 %	374,789	1,246	1.32 %
Noninterest-bearing demand deposits	104,795	-	-	101,304	-	-
Funding and cost of funds	471,744	860	0.72 %	476,093	1,246	1.04 %
Other noninterest-bearing liabilities	5,425			5,004		
Total Liabilities	477,169			481,097		
Stockholders' Equity	48,500			52,386		
Total Liabilities and Stockholders' Equity	\$ 525,669			\$ 533,483		

Net interest income	\$ 4,238	\$ 4,268
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)	3.17 %	3.00 %
Net interest margin (net interest income as a percentage of average interest-earning assets)	3.41 %	3.34 %

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

(Dollar amounts in thousands)	Three months ended September 30, 2013 versus 2012		
	Increase (Decrease) due to		Total
	Volume	Rate	
Interest income:			
Loans	\$ 126	\$ (398)	\$ (272)
Securities	(103)	(39)	(142)
Interest-earning deposits with banks	(9)	4	(5)
Federal bank stocks	2	1	3
 Total interest-earning assets	 16	 (432)	 (416)
Interest expense:			
Interest-bearing deposits	(60)	(286)	(346)
Borrowed funds	120	(160)	(40)
 Total interest-bearing liabilities	 60	 (446)	 (386)
 Net interest income	 \$ (44)	 \$ 14	 \$ (30)

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

Information pertaining to the allowance for loan losses and nonperforming assets for the three months ended September 30, 2013 and 2012 is as follows:

(Dollar amounts in thousands)	At or for the three months ended	
	September 30, 2013	2012
Balance at the beginning of the period	\$ 4,670	\$ 3,715
Provision for loan losses	143	1,359
Charge-offs	(33)	(59)
Recoveries	7	8
Balance at the end of the period	\$ 4,787	\$ 5,023
 Nonperforming loans	 \$ 5,310	 \$ 7,353
Nonperforming assets	5,458	7,656

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Nonperforming loans to total loans	1.51	%	2.19	%
Nonperforming assets to total assets	1.04	%	1.44	%
Allowance for loan losses to total loans	1.36	%	1.49	%
Allowance for loan losses to non-performing loans	90.14	%	68.31	%

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Nonperforming loans decreased \$2.0 million to \$5.3 million at September 30, 2013 from \$7.4 million at September 30, 2012. The decrease in nonperforming loans was primarily due to a \$941,000 partial charge-off in the second quarter of 2013 of a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 due to cash flow considerations, weakened financial condition of the principals and guarantors and updated appraisal information. This loan had a specific reserve of \$1.4 million which was established in the third quarter of 2012. Also contributing to the decrease were principal reductions resulting from credit workouts and repayments. Of the \$5.3 million in nonperforming loans, the Corporation continues to receive payments on \$4.2 million. During the three months ended September 30, 2013, nonperforming loans decreased \$19,000.

As of September 30, 2013, the Corporation's classified and criticized assets amounted to \$12.9 million, or 2.5% of total assets, with \$12.0 million classified as substandard and \$948,000 identified as special mention. This compares to classified and criticized assets of \$15.4 million, or 3.0% of total assets, with \$10.2 million classified as substandard, \$3.8 million identified as special mention and \$1.4 million classified as doubtful at December 31, 2012. The overall decrease in criticized and classified assets was primarily the result of the aforementioned partial charge-off and principal reductions resulting from credit workouts and repayments.

The provision for loan losses decreased \$1.2 million, or 89.5%, to \$143,000 for the three months ended September 30, 2013 from \$1.4 million for the same period in the prior year as \$1.4 million in specific reserves was allocated to the aforementioned \$3.4 million commercial credit relationship during the three months ended September 30, 2012.

**Noninterest income.** Noninterest income decreased \$371,000, or 27.0%, to \$1.0 million for the three months ended September 30, 2013, compared to \$1.4 million for the same period in the prior year. This decrease was primarily due to decreases in gains on the sale of securities and commissions on financial services of \$283,000 and \$110,000, respectively. During the quarter ended September 30, 2013, the Corporation realized securities gains of \$107,000 related primarily to the sale of certain municipal and mortgage-backed securities. During the same period in 2012, the Corporation realized securities gains of \$390,000 related to the sale of mortgage-backed securities. Partially offsetting these decreases, earnings on bank-owned life insurance increased by \$16,000. During the third quarter of 2012, the Corporation purchased an additional \$4.0 million of bank-owned life insurance, thereby increasing its total investment to over \$10.0 million. Excluding security gains, noninterest income decreased \$88,000, or 9.0%, to \$895,000 for the three months ended September 30, 2013, compared to \$983,000 for the same period in the prior year.

**Noninterest expense.** Noninterest expense increased \$186,000, or 5.5%, to \$3.5 million for the three months ended September 30, 2013. This increase in noninterest expense can be attributed to increases in compensation and employee benefits expense, premise and equipment expense, professional fees and FDIC expense of \$169,000, \$7,000, \$23,000 and \$7,000, respectively, partially offset by decreases in intangible amortization and other noninterest expense of \$19,000 and \$2,000, respectively.

Compensation and employee benefits expense increased \$169,000, or 10.1%, to \$1.8 million for the three months ended September 30, 2013, compared to \$1.7 million for the same period in the prior year. This increase can be primarily attributed to a \$160,000 reduction in incentive compensation accruals in the third quarter of 2012 given the elevated level of provision for loan losses realized in the period. Excluding the incentive compensation adjustment in 2012, compensation and benefits exhibited an increase of 0.5%.

Premise and equipment expense increased \$7,000, or 1.4%, to \$516,000 for the three months ended September 30, 2013, compared to \$509,000 for the same period in the prior year. This increase can be primarily attributed to a \$16,000 increase in office rent related to the lease of temporary office space in Cranberry Township, Pennsylvania and a new branch banking office in Saint Marys, Pennsylvania.

Professional fees increased \$23,000, or 17.0%, to \$158,000 for the three months ended September 30, 2013, compared to \$135,000 for the same period in the prior year. This increase can be primarily attributed to increased legal and accounting fees.

The Corporation recognized \$67,000 of core deposit intangible amortization expense during the third quarter of 2013 compared to \$86,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.

FDIC insurance increased \$7,000, or 7.6%, to \$99,000 for the three months ended September 30, 2013, compared to \$92,000 for the same period in the prior year. The increase was primarily the result of an increase in the Bank’s FDIC insurance assessment rate following prior period increases in nonperforming assets, loans past due 30-89 days and net loan charge-offs.

**Provision for income taxes.** The provision for income taxes increased \$205,000 to \$272,000 for the three months ended September 30, 2013 compared to \$67,000 for the same period in the prior year. The Corporation’s effective tax rate increased to 20.1% for the third quarter of 2013 from 9.1% for the same quarter in the prior year due to an increase in taxable income. The difference between the statutory rate of 34% and the Corporation’s effective tax rate of 20.1% for the quarter ended September 30, 2013 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

#### *Comparison of Results for the Nine Months Ended September 30, 2013 and 2012*

**General.** Net income before preferred stock dividends decreased \$84,000, or 2.8%, to \$2.9 million for the nine months ended September 30, 2013 from \$3.0 million for the same period in 2012. This decrease was the result of decreases in net interest income and noninterest income of \$112,000 and \$1.0 million, respectively, and an increase in noninterest expense of \$195,000, partially offset by decreases in the provision for loan losses and the provision for income taxes of \$1.1 million and \$124,000, respectively.

**Net interest income.** Net interest income on a tax equivalent basis decreased \$113,000, or 0.9%, to \$12.4 million for the nine months ended September 30, 2013 from \$12.5 million for the same period in 2012. This decrease can be attributed to a decrease in tax equivalent interest income of \$1.0 million, partially offset by a decrease in interest expense of \$917,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$1.0 million, or 6.3%, to \$15.3 million for the nine months ended September 30, 2013 compared to \$16.3 million for the nine months ended September 30, 2012. This decrease can be attributed to decreases in interest on loans, securities and interest-earning deposits with banks of \$571,000, \$441,000 and \$24,000, respectively, partially offset by an increase in interest earned on federal bank stocks of \$6,000.

Tax equivalent interest earned on loans receivable decreased \$571,000, or 4.3%, to \$12.6 million for the nine months ended September 30, 2013 compared to \$13.2 million for the nine months ended September 30, 2012. This decrease resulted from a 45 basis point decline in the average yield on loans to 4.95% for the nine months ended September 30, 2013, versus 5.40% for the same period in 2012. This unfavorable yield variance accounted for a \$1.1 million decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$14.3 million, or 4.4%, accounting for an increase of \$560,000 in loan interest income. Management’s strategy to increase loan production capacity, which includes the expansion of the corporate banking team and the projected entrance into new markets in the coming quarters, is key to overcoming the decrease in loan yields caused by an overall decline in market interest rates.

Tax equivalent interest earned on securities decreased \$441,000, or 14.7%, to \$2.6 million for the nine months ended September 30, 2013 compared to \$3.0 million for the nine months ended September 30, 2012. This decrease resulted from a 24 basis point decline in the average yield on securities to 2.59% for the nine months ended September 30, 2013, versus 2.83% for the same period in 2012, due primarily to the sale of higher-yielding securities. This



unfavorable yield variance accounted for a \$242,000 decrease in interest income. Additionally, the average balance of securities decreased \$9.8 million, or 6.9%, accounting for a \$199,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$917,000, or 24.1%, to \$2.9 million for the nine months ended September 30, 2013 from \$3.8 million for the same period in 2012. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$800,000 and \$117,000, respectively.

Interest expense incurred on deposits decreased \$800,000, or 25.8%, to \$2.3 million for the nine months ended September 30, 2013 compared to \$3.1 million for the same period in 2012. The average cost of interest-bearing deposits decreased 26 basis points to 0.92% for the nine months ended September 30, 2013, compared to 1.18% for the same period in 2012, resulting in a \$664,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during late 2012 and the first nine months of 2013 in the prevailing low interest-rate environment. Additionally, the average balance of interest-bearing deposits decreased \$16.0 million, or 4.6%, to \$334.5 million for the nine months ended September 30, 2013, compared to \$350.4 million for the same period in 2012, causing a \$136,000 decrease in interest expense. Average noninterest bearing deposits increased \$8.6 million, or 9.1%, to \$103.3 million from \$94.6 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$117,000, or 16.5%, to \$590,000 for the nine months ended September 30, 2013, compared to \$707,000 for the same period in the prior year. The average cost of borrowed funds decreased 162 basis points to 3.10% for the nine months ended September 30, 2013, compared to 4.72% for the same period in 2012, causing a \$279,000 decrease in interest expense. The decrease was the result of the Corporation exchanging and modifying \$15.0 million of the \$20.0 million in outstanding Federal Home Loan Bank (FHLB) advances during the fourth quarter of 2012. The modification reduced the average rate on the \$15.0 million of advances from 4.83% to 0.93%. Prepayment penalties totaling \$2.3 million were cash-settled at the time of modification and are being amortized over five years, the life of the new advances. In addition, short-term borrowings were utilized during the first nine months of 2013 with an average rate of 0.34%. Partially offsetting the favorable rate variance, the average balance of borrowed funds increased \$5.4 million, or 27.1%, to \$25.4 million for the nine months ended September 30, 2013, compared to \$20.0 million for the same period in 2012 as the Corporation utilized short-term borrowings, which caused a \$162,000 increase in interest expense.

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

(Dollar amounts in thousands)	Nine months ended September 30, 2013				2012			
	Average Balance	Interest	Yield / Rate		Average Balance	Interest	Yield / Rate	
<b>Interest-earning assets:</b>								
Loans, taxable	\$ 322,675	\$ 11,923	4.94 %		\$ 305,774	\$ 12,504	5.46 %	
Loans, tax exempt	18,204	698	5.13 %		20,834	688	4.41 %	
Total loans receivable	340,879	12,621	4.95 %		326,608	13,192	5.40 %	
Securities, taxable	91,020	1,328	1.95 %		105,010	1,763	2.24 %	
Securities, tax exempt	40,937	1,233	4.03 %		36,720	1,239	4.51 %	
Total securities	131,957	2,561	2.59 %		141,730	3,002	2.83 %	
Interest-earning deposits with banks	13,295	44	0.44 %		26,075	68	0.35 %	
Federal bank stocks	3,124	52	2.23 %		3,433	46	1.79 %	
Total interest-earning cash equivalents	16,419	96	0.78 %		29,508	114	0.52 %	
Total interest-earning assets	489,255	15,278	4.17 %		497,846	16,308	4.38 %	
Cash and due from banks	2,023				2,482			
Other noninterest-earning assets	28,167				21,504			
<b>Total assets</b>	<b>\$ 519,445</b>				<b>\$ 521,832</b>			
<b>Interest-bearing liabilities:</b>								
Interest-bearing demand deposits	\$ 215,136	\$ 258	0.16 %		\$ 209,540	\$ 350	0.22 %	
Time deposits	119,327	2,047	2.29 %		140,882	2,755	2.61 %	
Total interest-bearing deposits	334,463	2,305	0.92 %		350,422	3,105	1.18 %	
Borrowed funds, long-term	20,000	576	3.85 %		20,000	707	4.72 %	
Borrowed funds, short-term	5,438	14	0.34 %		15	-	0.00 %	
Total borrowed funds	25,438	590	3.10 %		20,015	707	4.72 %	
Total interest-bearing liabilities	359,901	2,895	1.08 %		370,437	3,812	1.37 %	
Noninterest-bearing demand deposits	103,255	-	-		94,630	-	-	
Funding and cost of funds	463,156	2,895	0.84 %		465,067	3,812	1.09 %	
Other noninterest-bearing liabilities	5,594				5,044			
Total liabilities	468,750				470,111			
Stockholders' equity	50,695				51,721			
<b>Total liabilities and stockholders' equity</b>	<b>\$ 519,445</b>				<b>\$ 521,832</b>			

Net interest income	\$ 12,383		\$ 12,496
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)		3.09 %	3.01 %
Net interest margin (net interest income as a percentage of average interest-earning assets)		3.38 %	3.35 %

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

(Dollar amounts in thousands)	Nine months ended September 30, 2013 versus 2012		
	Increase (Decrease) due to		Total
	Volume	Rate	
Interest income:			
Loans	\$ 560	\$ (1,131)	\$ (571)
Securities	(199)	(242)	(441)
Interest-earning deposits with banks	(39)	15	(24)
Federal bank stocks	(4)	10	6
Total interest-earning assets	318	(1,348)	(1,030)
Interest expense:			
Deposits	(136)	(664)	(800)
Borrowed funds	162	(279)	(117)
Total interest-bearing liabilities	26	(943)	(917)
Net interest income	\$ 292	\$ (405)	\$ (113)

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

Information pertaining to the allowance for loan losses and nonperforming assets for the nine months ended September 30, 2013 and 2012 is as follows:

(Dollar amounts in thousands)	At or for the nine months ended	
	September 30, 2013	2012
Balance at the beginning of the period	\$ 5,350	\$ 3,536
Provision for loan losses	438	1,587
Charge-offs	(1,047)	(247)
Recoveries	46	147
Balance at the end of the period	\$ 4,787	\$ 5,023
Non-performing loans	\$ 5,310	\$ 7,353
Non-performing assets	5,458	7,656

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Non-performing loans to total loans	1.51	%	2.19	%
Non-performing assets to total assets	1.04	%	1.44	%
Allowance for loan losses to total loans	1.36	%	1.49	%
Allowance for loan losses to non-performing loans	90.14	%	68.31	%

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Nonperforming loans decreased \$2.0 million to \$5.3 million at September 30, 2013 from \$7.4 million at September 30, 2012. The decrease in nonperforming loans was primarily due to a \$941,000 partial charge-off in the second quarter of 2013 of a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 due to cash flow considerations, weakened financial condition of the principals and guarantors and updated appraisal information. This loan had a specific reserve of \$1.4 million which was established in the third quarter of 2012. Also contributing to the decrease were principal reductions resulting from credit workouts and repayments. Of the \$5.3 million in nonperforming loans, the Corporation continues to receive payments on \$4.2 million. During the nine months ended September 30, 2013, nonperforming loans decreased \$1.7 million to \$5.3 million from \$7.0 million at December 31, 2012.

As of September 30, 2013, the Corporation's classified and criticized assets amounted to \$12.9 million, or 2.5% of total assets, with \$12.0 million classified as substandard and \$948,000 identified as special mention. This compares to classified and criticized assets of \$15.4 million, or 3.0% of total assets, with \$10.2 million classified as substandard, \$3.8 million identified as special mention and \$1.4 million classified as doubtful at December 31, 2012. The overall decrease in criticized and classified assets was primarily the result of the aforementioned partial charge-off and principal reductions resulting from credit workouts and repayments.

The provision for loan losses decreased \$1.1 million, or 72.4%, to \$438,000 for the nine months ended September 30, 2013 from \$1.6 million for the same period in the prior year as the results for the third quarter of 2012 included provision expense of \$1.4 million related to the aforementioned \$3.4 million commercial credit relationship. Net charge-offs for the nine months ended September 30, 2013 were \$1.0 million, compared to \$247,000 for the same period in 2012 due to the aforementioned partial charge-off. This loan had sufficient specific reserves allocated to cover the charge-off, however, the charge-off negatively impacted the historical loss factors requiring additional provision for loan losses for the non-owner occupied commercial real estate loan portfolio.

**Noninterest income.** Noninterest income decreased \$1.0 million or 26.2%, to \$3.0 million for the nine months ended September 30, 2013, compared to \$4.0 million for the same period in the prior year. This decrease was primarily due to decreases in gains on the sale of securities and commissions on financial services of \$1.1 million and \$196,000, respectively. During the nine months ended September 30, 2013, the Corporation realized securities gains of \$291,000. During the same period in 2012, the Corporation realized securities gains of \$1.4 million, \$424,000 of which related to the sale of a community bank stock, \$538,000 related to the sale of U.S. Treasury securities and \$390,000 related to the sale of certain mortgage-backed securities. Partially offsetting these decreases, fees and service charges and earnings on bank-owned life insurance increased by \$95,000 and \$85,000, respectively. During the third quarter of 2012, the Corporation purchased an additional \$4.0 million of bank-owned life insurance, thereby increasing its total investment to over \$10.0 million. Excluding securities gains, noninterest income increased \$11,000, to \$2.7 million during the nine months ended September 30, 2013.

**Noninterest expense.** Noninterest expense increased \$195,000 to \$10.8 million for the nine months ended September 30, 2013, compared to \$10.6 million for the same period in the prior year. This increase in noninterest expense can be attributed to increases in compensation and employee benefits expense, premise and equipment expense, FDIC expense and professional fees of \$196,000, \$59,000, \$25,000 and \$3,000, respectively, partially offset by decreases in intangible amortization and other noninterest expense of \$59,000 and \$29,000, respectively.

Compensation and employee benefits expense increased \$196,000, or 3.6%, to \$5.7 million for the nine months ended September 30, 2013, compared to \$5.5 million for the same period in the prior year. This increase is primarily attributed to normal salary and wage increases of \$228,000 and increases in stock compensation expense, directors fees and incentive compensation of \$41,000, \$48,000 and \$105,000, respectively, partially offset by a \$130,000 reduction in employee retirement expense related to the pension plan freeze and decreases of \$22,000 and \$57,000 in payroll taxes and commission expense, respectively.

The Corporation recognized \$213,000 of core deposit intangible amortization expense during the first nine months of 2013 compared to \$272,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.



Premises and equipment expense increased \$59,000, or 3.9%, to \$1.6 million for the nine months ended September 30, 2013, compared to \$1.5 million for the same period in the prior year. This increase is primarily attributed to increases of \$26,000, \$11,000 \$12,000 and \$12,000 in office rent, utility expense, real estate taxes and equipment service contracts, respectively.

FDIC insurance increased \$25,000, or 8.9%, to \$307,000 for the nine months ended September 30, 2013, compared to \$282,000 for the same period in the prior year. The increase relates to an increase in the Bank's FDIC insurance assessment rate following prior period increases in nonperforming assets, loans past due 30-89 days and net loan charge-offs.

**Provision for income taxes.** The provision for income taxes decreased \$124,000, or 14.9%, to \$711,000 for the nine months ended September 30, 2013 compared to \$835,000 for the same period in the prior year. The Corporation's effective tax rate decreased to 19.8% for the first nine months of 2013 from 22.0% for the same period in the prior year due to a decrease in taxable income. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 19.8% for the period ended September 30, 2013, was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## LIQUIDITY

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB and Federal Reserve, and amortization and prepayments of outstanding loans and maturing securities. During the nine months ended September 30, 2013, the Corporation used its sources of funds primarily to fund loan originations and security purchases. As of September 30, 2013, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$48.5 million, and standby letters of credit totaling \$193,000.

At September 30, 2013, time deposits amounted to \$107.6 million, or 25.1% of the Corporation's total consolidated deposits, including approximately \$35.6 million of which are scheduled to mature within the next year. Management of the Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve's discount window. At September 30, 2013, the Corporation had borrowed funds of \$46.7 million consisting of \$20.0 million in long-term FHLB advances, \$24.5 million in FHLB overnight advances and a \$2.2 million short-term advance on a line of credit with a correspondent bank. The short-term borrowed funds were utilized primarily to offset deposit fluctuations within the quarter and to fund a portion of the \$5.0 million redemption of preferred shares that had been issued to the Treasury in August 2011 through the SBLF Program. Following this redemption, the Treasury holds 5,000 shares of preferred stock, representing a remaining liquidation value to \$5.0 million. For the two-year period beginning with the quarter ending March 31, 2014, the dividend rate on the preferred stock will be fixed at a rate of 1% to 7% per annum. If the preferred stock remains outstanding for more than four-and-one-half years, beginning in the quarter ending March 31, 2016, the dividend rate will be fixed at 9%. The dividend rate was 5.0% and 4.72%, respectively, for the quarters ended September 30, 2013 and 2012. For the two-year period beginning with the quarter ending March 31, 2014, the dividend rate will be fixed at 2.0%. At September 30, 2013, the Corporation's borrowing capacity with the FHLB, net of funds borrowed, was \$131.0 million.

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



## **RECENT REGULATORY DEVELOPMENTS**

In July 2013, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule established a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets), phases out certain kinds of intangibles and instruments treated as capital and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain “available-for-sale” securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-out is exercised. The rule limits a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The new capital rules maintain the general structure of the prompt corrective action rules, but incorporate the new common equity Tier 1 capital requirement and the increased Tier 1 risk-weighted asset requirement into the prompt corrective action framework.

The final rule becomes effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. The final rule also implements consolidated capital requirements for bank holding companies, such as the Corporation, effective January 1, 2015.

## **CRITICAL ACCOUNTING POLICIES**

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

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2012. These policies, along with the disclosures presented in the other financial statement notes provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies.



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

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

**Goodwill and intangible assets.** Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step is to determine the amount of the impairment. If the tests conclude that goodwill is impaired, the carrying value is adjusted and an impairment charge is recorded. As of November 30, 2012, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date.

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

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

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

Interest rate sensitivity is the result of differences in the amounts and repricing dates of the Bank's rate sensitive assets and rate sensitive liabilities. These differences, or interest rate repricing "gap", provide an indication of the extent that the Corporation's net interest income is affected by future changes in interest rates. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities and is considered

negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

Assumptions about the timing and variability of cash flows are critical in gap analysis. Particularly important are the assumptions driving mortgage prepayments and the expected attrition of the core deposits portfolios. These assumptions are based on the Corporation's historical experience, industry standards and assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation's assets and liabilities to interest rate changes. As of September 30, 2013, the Corporation's interest-earning assets maturing or repricing within one year totaled \$175.3 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$165.3 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$10.0 million. At September 30, 2013, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 106.0%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

#### **Item 4. Controls and Procedures**

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

As of September 30, 2013, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective. There have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

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

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

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

### **Item 1A. Risk Factors**

There have been no material changes from those risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2012, as filed with the Securities and Exchange Commission. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

<b>Exhibit 31.1</b>	Rule 13a-14(a) Certification of Principal Executive Officer
<b>Exhibit 31.2</b>	Rule 13a-14(a) Certification of Principal Financial Officer
<b>Exhibit 32.1</b>	CEO Certification Pursuant to 18 U.S.C. Section 1350
<b>Exhibit 32.2</b>	CFO Certification Pursuant to 18 U.S.C. Section 1350
<b>101.INS</b>	XBRL Instance Document*
<b>101.SCH</b>	XBRL Taxonomy Extension Schema Document*
<b>101.CAL</b>	XBRL Taxonomy Extension Calculation Linkbase Document*
<b>101.DEF</b>	XBRL Taxonomy Extension Definitions Linkbase Document*
<b>101.LAB</b>	XBRL Taxonomy Extension Label Linkbase Document*
<b>101.PRE</b>	XBRL Taxonomy Extension Presentation Linkbase Document*

**Signatures**

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

EMCLAIRE FINANCIAL CORP

Date: November 12, 2013

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

Date: November 12, 2013

By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer