

EMCLAIRE FINANCIAL CORP  
Form 10-K  
March 24, 2017

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

FORM 10-K  
(Mark One):

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

For the fiscal year ended: December 31, 2016

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

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

Commission File Number: 000-18464

EMCLAIRE FINANCIAL CORP

(Exact name of registrant as specified in its charter)

Pennsylvania

25-1606091

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

612 Main Street, Emlenton, PA 16373

(Address of principal executive office) (Zip Code)

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

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

Common Stock, par value \$1.25 per share NASDAQ Capital Markets (NASDAQ)

(Title of Class) (Name of exchange on which registered)

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

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

YES  NO .

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

YES  NO .

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

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

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

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

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

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

As of June 30, 2016, the aggregate value of the 1,825,718 shares of Common Stock of the Registrant issued and outstanding on such date, which excludes 320,590 shares held by the directors and officers of the Registrant as a group, was approximately \$43.7 million. This figure is based on the last sales price of \$23.94 per share of the Registrant's Common Stock on June 30, 2016. The number of outstanding shares of common stock as of March 24, 2017, was 2,152,358.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2017 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

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EMCLAIRE FINANCIAL CORP

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

## PART I

### Item 1. Business

#### General

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

The Bank was organized in 1900 as a national banking association and is a financial intermediary whose principal business consists of attracting deposits from the general public and investing such funds in real estate loans secured by liens on residential and commercial property, consumer loans, commercial business loans, marketable securities and interest-earning deposits. The Bank currently operates through a network of seventeen retail branch offices in Venango, Allegheny, Butler, Clarion, Clearfield, Crawford, Elk, Jefferson and Mercer counties, Pennsylvania. The Corporation and the Bank are headquartered in Emlenton, Pennsylvania.

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

On April 30, 2016, the Corporation completed its acquisition of United American Savings Bank (United American or UASB) in accordance with the terms of the Agreement and Plan of Merger, dated December 30, 2015, by and among the Corporation, the Bank and United American (the Merger Agreement). Pursuant to the Merger Agreement, the Corporation acquired United American through a reverse merger of a newly created, wholly-owned subsidiary of the Bank into United American. Immediately after the merger, United American merged with and into The Farmers National Bank of Emlenton, with The Farmers National Bank of Emlenton being the surviving bank. The Corporation acquired all of the outstanding shares of common stock of United American for cash consideration of \$13.2 million (\$42.67 per share).

At December 31, 2016, the Corporation had \$692.1 million in total assets, \$54.1 million in stockholders' equity, \$515.4 million in net loans and \$584.9 million in total deposits.

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## Lending Activities

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

One-to-Four Family Mortgage Loans. The Corporation offers first mortgage loans secured by one-to-four family residences located mainly in the Corporation's primary lending area. One-to-four family mortgage loans amounted to 38.0% of the total loan portfolio at December 31, 2016. Typically such residences are single-family owner occupied units. The Corporation is an approved, qualified lender for the Federal Home Loan Mortgage Corporation (FHLMC) and the FHLB. As a result, the Corporation may sell loans to and service loans for the FHLMC and FHLB in market conditions and circumstances where this is advantageous in managing interest rate risk.

Home Equity Loans. The Corporation originates home equity loans secured by single-family residences. Home equity loans amounted to 17.5% of the total loan portfolio at December 31, 2016. These loans may be either a single advance fixed-rate loan with a term of up to 20 years or a variable rate revolving line of credit. These loans are made only on owner-occupied single-family residences.

Commercial Business and Commercial Real Estate Loans. Commercial lending constitutes a significant portion of the Corporation's lending activities. Commercial business and commercial real estate loans amounted to 43.2% of the total loan portfolio at December 31, 2016. Commercial real estate loans generally consist of loans granted for commercial purposes secured by commercial or other nonresidential real estate. Commercial loans consist of secured and unsecured loans for such items as capital assets, inventory, operations and other commercial purposes.

Consumer Loans. Consumer loans generally consist of fixed-rate term loans for automobile purchases, home improvements not secured by real estate, capital and other personal expenditures. The Corporation also offers unsecured revolving personal lines of credit and overdraft protection. Consumer loans amounted to 1.3% of the total loan portfolio at December 31, 2016.

Loans to One Borrower. National banks are subject to limits on the amount of credit that they can extend to one borrower. Under current law, loans to one borrower are limited to an amount equal to 15% of unimpaired capital and surplus on an unsecured basis, and an additional amount equal to 10% of unimpaired capital and surplus if the loan is secured by readily marketable collateral. At December 31, 2016, the Bank's loans to one borrower limit based upon 15% of unimpaired capital was \$8.8 million. The Bank may grant credit to borrowers in excess of the legal lending limit as part of the Legal Lending Limit Pilot Program approved by the OCC which allows the Bank to exceed its legal lending limit within certain parameters. At December 31, 2016, the Bank's largest single lending relationship had an outstanding balance of \$6.9 million.

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

(Dollar amounts in thousands)	2016		2015		2014		2013		2012	
	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%
Mortgage loans on real estate:										
Residential first mortgages	\$ 198,167	38.0 %	\$ 139,305	32.0 %	\$ 139,305	27.8 %	\$ 105,541	29.5 %	\$ 97,246	28.7 %
Home equity loans and lines of credit	91,359	17.5 %	87,410	20.1 %	87,410	23.2 %	87,928	24.6 %	85,615	25.2 %
Commercial real estate	166,994	32.1 %	129,691	29.8 %	129,691	28.8 %	101,499	28.5 %	98,823	29.2 %
Total real estate loans	456,520	87.6 %	356,406	81.9 %	307,089	79.8 %	294,968	82.6 %	281,684	83.1 %
Other loans:										
Commercial business	57,788	11.1 %	71,948	16.5 %	70,185	18.2 %	53,214	14.9 %	45,581	13.4 %
Consumer	6,672	1.3 %	6,742	1.6 %	7,598	2.0 %	9,117	2.6 %	11,886	3.5 %
Total other loans	64,460	12.4 %	78,690	18.1 %	77,783	20.2 %	62,331	17.4 %	57,467	16.9 %
Total loans receivable	520,980	100.0 %	435,096	100.0 %	384,872	100.0 %	357,299	100.0 %	339,151	100.0 %
Less:										
Allowance for loan losses	5,545		5,205		5,224		4,869		5,350	
Net loans receivable	\$ 515,435		\$ 429,891		\$ 379,648		\$ 352,430		\$ 333,801	

The following table sets forth the final maturity of loans in the Corporation's portfolio as of December 31, 2016. Demand loans having no stated schedule of repayment and no stated maturity are reported as due within one year.

(Dollar amounts in thousands)	Due in one year or less	Due from one to five years	Due from five to ten years	Due after ten years	Total
Residential mortgages	\$ 6,557	\$ 3,603	\$ 13,233	\$ 174,774	\$ 198,167
Home equity loans and lines of credit	1,044	9,469	23,093	57,753	91,359
Commercial real estate	1,157	13,599	53,454	98,784	166,994
Commercial business	1,312	16,434	11,211	28,831	57,788
Consumer	126	3,492	1,370	1,684	6,672
	\$ 10,196	\$ 46,597	\$ 102,361	\$ 361,826	\$ 520,980

The following table sets forth the dollar amount of the Corporation's fixed and adjustable rate loans with maturities greater than one year as of December 31, 2016:

(Dollar amounts in thousands)	Fixed rates	Adjustable rates
Residential mortgages	\$ 180,213	\$ 11,397
Home equity loans and lines of credit	76,082	14,233
Commercial real estate	34,329	131,508
Commercial business	24,170	32,306
Consumer	4,833	1,713



\$319,627 \$191,157

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

#### Delinquencies and Classified Assets

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

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

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

As of December 31, 2016, the Corporation's nonperforming assets were \$3.6 million, or 0.52% of the Corporation's total assets, compared to \$3.2 million or 0.54% of the Corporation's total assets, at December 31, 2015. Nonperforming assets at December 31, 2016 included nonaccrual loans and OREO of \$3.3 million and \$291,000, respectively. Included in nonaccrual loans at December 31, 2016 were 8 loans totaling \$239,000 considered to be troubled debt restructurings (TDRs).

Classified Assets. Regulations applicable to insured institutions require the classification of problem assets as "substandard," "doubtful," or "loss" depending upon the existence of certain characteristics as discussed below. A category designated "special mention" must also be maintained for assets currently not requiring the above classifications but having potential weakness or risk characteristics that could result in future problems. An asset is classified as substandard if not adequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. A substandard asset is characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified as substandard and these weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable or improbable. Assets classified as loss are considered uncollectible and of such little value that their continuance as assets is not warranted.

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

The Corporation regularly reviews the problem loans and other assets in its portfolio to determine whether any require classification in accordance with the Corporation's policy and applicable regulations. As of December 31, 2016, the Corporation's classified and criticized assets amounted to \$12.8 million or 1.9% of total assets, with \$6.0 million identified as special mention and \$6.8 million classified as substandard.

Included in classified and criticized assets at December 31, 2016 are two large loan relationships exhibiting credit deterioration that may impact the ability of the borrowers to comply with their present loan repayment terms on a timely basis.

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The first relationship, with an outstanding balance of \$4.5 million at December 31, 2016, consists of three commercial business loans. The loans are secured by lien positions on the accounts receivable, inventory and equipment of the borrower. In 2015, the borrower experienced significant gross margin compression due to rapid growth, write-off of obsolete inventory and job bidding mistakes, which resulted in deficit cash flows for the period. All obsolete inventory has been eliminated and bidding practices have been overhauled. Interim performance for 2016 indicates that gross margins are on pace to return to historical levels, with cash flow on pace to be adequate for debt service requirements. All loans have remained current, due in part to available liquidity on the borrower's balance sheet and the rapid turnaround in operating performance. At December 31, 2016, the loans were performing and classified as special mention. The rating and classification will be re-evaluated upon receipt and review of 2016 financial statements.

The second loan, with an outstanding balance of \$2.6 million at December 31, 2016, was originated for the construction of a hotel, restaurant and retail plaza secured by such property and the borrower's personal residence. The hotel, restaurant and retail plaza are complete and operational. However, cash flows from operations have not been consistent and are impacted by the seasonal nature of the hotel. In addition, the borrower has limited liquidity. As a result, the borrower has listed substantial real estate holdings for sale. At December 31, 2016, the loan was performing and classified as substandard. Ultimately, due to the estimated value of the borrower's significant real estate holdings, the Corporation does not currently expect to incur a loss on this loan.

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

(Dollar amounts in thousands)	2016	2015	2014	2013	2012
Nonperforming loans	\$3,323	\$3,069	\$6,942	\$5,207	\$6,988
Total as a percentage of gross loans	0.64 %	0.71 %	1.80 %	1.46 %	2.06 %
Repossessions	—	—	—	—	—
Real estate acquired through foreclosure	291	160	124	107	180
Total as a percentage of total assets	0.04 %	0.03 %	0.02 %	0.02 %	0.04 %
Total nonperforming assets	\$3,614	\$3,229	\$7,066	\$5,314	\$7,168
Total nonperforming assets as a percentage of total assets	0.52 %	0.54 %	1.21 %	1.01 %	1.41 %
Allowance for loan losses as a percentage of nonperforming loans	166.87 %	169.60 %	75.25 %	93.51 %	76.56 %

Allowance for Loan Losses. Management establishes allowances for estimated losses on loans based upon its evaluation of the pertinent factors underlying the types and quality of loans; historical loss experience based on volume and types of loans; trend in portfolio volume and composition; level and trend of nonperforming assets; detailed analysis of individual loans for which full collectability may not be assured; determination of the existence and realizable value of the collateral and guarantees securing such loans and the current economic conditions affecting the collectability of loans in the portfolio. The Corporation analyzes its loan portfolio at least quarterly for valuation purposes and to determine the adequacy of its allowance for loan losses. Based upon the factors discussed above, management believes that the Corporation's allowance for loan losses as of December 31, 2016 of \$5.5 million was adequate to cover probable incurred losses in the portfolio at such time.

The following table sets forth an analysis of the allowance for losses on loans receivable for the years ended December 31:

(Dollar amounts in thousands)	2016	2015	2014	2013	2012
Balance at beginning of period	\$5,205	\$5,224	\$4,869	\$5,350	\$3,536
Provision for loan losses	464	381	670	580	2,154
Charge-offs:					
Residential mortgage loans	(101 )	(79 )	(134 )	(36 )	(90 )
Home equity loans and lines of credit	(118 )	(221 )	(72 )	(68 )	(222 )
Commercial real estate loans	(18 )	(35 )	(2 )	(941 )	(35 )
Commercial business loans	(11 )	(182 )	(17 )	—	(50 )
Consumer loans	(48 )	(50 )	(139 )	(85 )	(101 )
	(296 )	(567 )	(364 )	(1,130 )	(498 )
Recoveries:					
Residential mortgage loans	—	—	—	1	84
Home equity loans and lines of credit	3	30	1	—	27
Commercial real estate loans	158	88	18	8	8
Commercial business loans	—	31	7	18	15
Consumer loans	11	18	23	42	24
	172	167	49	69	158
Net charge-offs	(124 )	(400 )	(315 )	(1,061 )	(340 )
Balance at end of period	\$5,545	\$5,205	\$5,224	\$4,869	\$5,350
Ratio of net charge-offs to average loans outstanding	0.03 %	0.10 %	0.08 %	0.30 %	0.10 %
Ratio of allowance to total loans at end of period	1.06 %	1.20 %	1.36 %	1.36 %	1.58 %

If the loans acquired from UASB during the year with balances of \$58.9 million were excluded, the ratio of allowance to total loans at December 31, 2016 would have been 1.20%.

The following table provides a breakdown of the allowance for loan losses by major loan category for the years ended December 31:

(Dollar amounts in thousands)	2016		2015		2014		2013		2012	
	Dollar Amount	Percent of loans in each category to total loans	Dollar Amount	Percent of loans in each category to total loans	Dollar Amount	Percent of loans in each category to total loans	Dollar Amount	Percent of loans in each category to total loans	Dollar Amount	Percent of loans in each category to total loans
Residential mortgages	\$1,846	38.0 %	\$1,429	32.0 %	\$955	27.8 %	\$923	29.5 %	\$828	28.7 %
	633	17.5 %	586	20.1 %	543	23.2 %	625	24.6 %	730	25.2 %

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Home equity loans and lines of credit

Commercial real estate	2,314	32.1 %	2,185	29.8 %	2,338	28.8 %	2,450	28.4 %	3,090	29.2 %
Commercial business	700	11.1 %	960	16.5 %	1,336	18.2 %	822	14.9 %	636	13.4 %
Consumer loans	52	1.3 %	45	1.6 %	52	2.0 %	49	2.6 %	66	3.5 %
	\$5,545	100 %	\$5,205	100 %	\$5,224	100 %	\$4,869	100 %	\$5,350	100 %

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## Investment Activities

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

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

The following table sets forth certain information regarding the fair value, weighted average yields and contractual maturities of the Corporation's securities as of December 31, 2016:

	Due in 1	Due from 1	Due from 3	Due from 5	Due after	No		
(Dollar amounts in thousands)	year or less	to 3 years	to 5 years	to 10 years	10 years	scheduled	Total	
U.S. Treasury and federal agency	\$—	\$ 494	\$ 3,002	\$ 1,004	\$—	\$—	\$ 4,500	
U.S. government sponsored entities and agencies	—	1,982	2,007	5,009	—	—	8,998	
U.S. agency mortgage-backed securities: residential	—	—	—	—	25,626	—	25,626	
U.S. agency collateralized mortgage obligations: residential	—	—	—	—	24,706	—	24,706	
Corporate securities	2,001	1,499	—	4,432	—	—	7,932	
State and political subdivision	—	2,384	9,366	14,882	976	—	27,608	
Equity securities	—	—	—	—	—	2,190	2,190	
Estimated fair value	\$ 2,001	\$ 6,359	\$ 14,375	\$ 25,327	\$ 51,308	\$ 2,190	\$ 101,560	
Weighted average yield (1)	1.19	% 2.25	% 2.68	% 3.30	% 2.01	% 3.36	% 2.45	%

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

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

(Dollar amounts in thousands)	2016	2015	2014
U.S. Treasury and federal agency	\$ 4,500	\$ 1,466	\$ 1,456
U.S. government sponsored entities and agencies	8,998	8,953	35,224
U.S. agency mortgage-backed securities: residential	25,626	33,150	38,771
U.S. agency collateralized mortgage obligations: residential	24,706	31,440	36,617
Corporate securities	7,932	7,487	1,998
State and political subdivision	27,608	28,591	33,024
Equity securities	2,190	1,894	2,771
	\$ 101,560	\$ 112,981	\$ 149,861

For additional information regarding the Corporation's investment portfolio see "Note 4 – Securities" to the consolidated financial statements on page F-14.

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## Sources of Funds

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

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

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

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

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

(Dollar amounts in thousands)	2016			2015		
	Weighted average rate	Amount	%	Weighted average rate	Amount	%
Non-interest bearing deposits	—	\$123,717	21.2 %	—	\$119,790	24.4 %
Interest bearing demand deposits	0.21 %	304,265	52.0 %	0.15 %	256,620	52.4 %
Time deposits	1.44 %	156,958	26.8 %	1.46 %	113,477	23.2 %
	0.50 %	\$584,940	100.0 %	0.42 %	\$489,887	100.0 %

The following table sets forth maturities of the Corporation's time deposits of \$100,000 or more at December 31, 2016 by time remaining to maturity:

(Dollar amounts in thousands)	Amount
Three months or less	\$4,914
Over three months to six months	7,246
Over six months to twelve months	11,489
Over twelve months	58,031
	\$81,680

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

(Dollar amounts in thousands)	2016	2015
Ending balance	\$44,000	\$49,250
Average balance	37,482	21,489
Maximum balance	52,750	55,750
Average rate	3.08 %	3.21 %

For additional information regarding the Corporation's deposit base and borrowed funds, see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Deposits and Borrowed Funds" in Item 7 and "Note 10 – Deposits" on page F-25 and "Note 11 – Borrowed Funds" on page F-26 to the consolidated financial statements.

### Subsidiary Activity

The Corporation has two wholly owned subsidiaries, the Bank and the Title Company. The Title Company provides real estate settlement services to the Bank and other customers. As of December 31, 2016, the Bank and the Title Company had no subsidiaries.

### Personnel

At December 31, 2016, the Corporation had 131 full time equivalent employees, compared to 122 at December 31, 2015. There is no collective bargaining agreement between the Corporation and its employees, and the Corporation believes its relationship with its employees is satisfactory.

### Competition

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

### Supervision and Regulation

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

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

The FRB may require the Corporation to terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB

also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances, the Corporation must file written notice and obtain FRB approval prior to purchasing or redeeming its equity securities.

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

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

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

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

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

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

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

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

insurance in the absence of action by the OCC and upon a finding that the Bank is operating in an unsafe or unsound condition, is engaging in unsafe or unsound activities, or that the Bank's conduct poses a risk to the deposit insurance fund or may prejudice the interest of its depositors.

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

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

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

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

implementing regulations to incentivize and protect individuals, commonly referred to as whistleblowers to report violations of federal securities laws.

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

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

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

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

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

In addition, Sections 22(g) and (h) of the Federal Reserve Act place restrictions on loans to executive officers, directors and principal shareholders of the national bank and its affiliates. Under Section 22(h), loans to a director, an executive officer and to a greater than 10% shareholder of a national bank, and certain affiliated interests of either, may not exceed, together with all other outstanding loans to such person and affiliated interests, the national bank’s loans to one borrower limit (generally equal to 15% of the bank’s unimpaired capital and surplus). Section 22(h) also requires that loans to directors, executive officers and principal shareholders be made on terms substantially the same as offered in comparable transactions to other persons unless the loans are made pursuant to a benefit or compensation program that (i) is widely available to employees of the bank and (ii) does not give preference to any director, executive officer or principal shareholder, or certain affiliated interests of either, over other employees of the national bank. Section 22(h) also requires prior board approval for certain loans. In addition, the aggregate amount of extensions of credit by a national bank to all insiders cannot exceed the bank’s unimpaired capital and surplus. Furthermore, Section 22(g) places additional restrictions on loans to executive officers. The Bank currently is subject to Sections 22(g) and (h) of the Federal Reserve Act and at December 31, 2016, was in compliance with the above restrictions.

Loans to One Borrower Limitations. With certain limited exceptions, the maximum amount that a national bank may lend to any borrower (including certain related entities of the borrower) at one time may not exceed 15% of the unimpaired capital and surplus of the institution, plus an additional 10% of unimpaired capital and surplus for loans fully secured by readily marketable collateral. At December 31, 2016, the Bank’s loans-to-one-borrower limit was \$8.8 million based upon the 15% of unimpaired capital and surplus measurement. The Bank may grant credit to borrowers in excess of the legal lending limit as part of the Legal Lending Limit Pilot Program approved by the OCC which



allows the Bank to exceed its legal lending limit within certain parameters. At December 31, 2016, the Bank's largest single lending relationship had an outstanding balance of \$6.9 million.

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

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

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

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

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

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

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

requirement to maintain consolidated regulatory capital ratios; instead, regulatory capital ratios only apply at the subsidiary bank level.

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

(Dollar amounts in thousands)	December 31, 2016		December 31, 2015	
	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets:				
Actual	\$58,605	12.69%	\$56,090	13.99%
For capital adequacy purposes	36,945	8.00 %	32,070	8.00 %
To be well capitalized	46,181	10.00%	40,087	10.00%
Tier 1 capital to risk-weighted assets:				
Actual	\$53,050	11.49%	\$51,073	12.74%
For capital adequacy purposes	27,709	6.00 %	24,052	6.00 %
To be well capitalized	36,945	8.00 %	32,070	8.00 %
Common Equity Tier 1 capital to risk-weighted assets:				
Actual	\$53,050	11.49%	\$51,073	12.74%
For capital adequacy purposes	20,781	4.50 %	18,039	4.50 %
To be well capitalized	30,018	6.50 %	26,057	6.50 %
Tier 1 capital to average assets:				
Actual	\$53,050	7.84 %	\$51,073	8.83 %
For capital adequacy purposes	27,081	4.00 %	23,131	4.00 %
To be well capitalized	33,852	5.00 %	28,914	5.00 %

Prompt Corrective Action and Other Enforcement Mechanisms. Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including but not limited to those institutions that fall below one or more prescribed minimum capital ratios. Each federal banking agency has promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on its capital ratios: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. At December 31, 2016, the Bank exceeded the required ratios for classification as “well capitalized.”

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

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Finally, pursuant to an interagency agreement, the FDIC can examine any institution that has a substandard regulatory examination score or is considered undercapitalized – without the permission of the institution’s primary regulator.

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

**Insurance of Accounts.** Deposit accounts are currently insured by the DIF generally up to a maximum of \$250,000 per separately insured depositor. As insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, insured institutions. It also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious threat to the FDIC. The FDIC also has the authority to initiate enforcement actions against insured institutions.

The Dodd Frank Act raises the minimum reserve ratio of the DIF from 1.15% to 1.35% and requires the FDIC to offset the effect of this increase on insured institutions with assets of less than \$10 billion (small institutions). In March 2016, the FDIC adopted a rule to accomplish this by imposing a surcharge on larger institutions commencing when the reserve ratio reaches 1.15% and ending when it reaches 1.35%. The reserve ratio reached 1.15% effective as of June 30, 2016. The surcharge period began effective July 1, 2016 and is expected to end by December 31, 2018. Small institutions will receive credits for the portion of their regular assessments that contributed to growth in the reserve ratio between 1.15% and 1.35%. The credits will apply to reduce regular assessments by 2.0 basis points for quarters when the reserve ratio is at least 1.38%.

Effective July 1, 2016, the FDIC adopted changes that eliminated its risk-based premium system. Under the new premium system, the FDIC assesses deposit insurance premiums on the assessment base of a depository institution, which is its average total assets reduced by the amount of its average tangible equity. For a small institution (one with assets of less than \$10 billion) that has been federally insured for at least five years, effective July 1, 2016, the initial base assessment rate ranges from 3 to 30 basis points, based on the institution's CAMELS composite and component ratings and certain financial ratios; its leverage ratio; its ratio of net income before taxes to total assets; its ratio of nonperforming loans and leases to gross assets; its ratio of other real estate owned to gross assets; its brokered deposits ratio (excluding reciprocal deposits if the institution is well capitalized and has a CAMELS composite rating of 1 or 2); its one year asset growth ratio (which penalizes growth adjusted for mergers in excess of 10%); and its loan mix index (which penalizes higher risk loans based on historical industry charge off rates). The initial base assessment rate is subject to downward adjustment (not below 1.5%) based on the ratio of unsecured debt the institution has issued to its assessment base, and to upward adjustment (which can cause the rate to exceed 30 basis points) based on its holdings of unsecured debt issued by other insured institutions. Institutions with assets of \$10 billion or more are assessed using a scorecard method.

In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately six tenths of a basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2017

through 2019.

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

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

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

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

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

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

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

The Equal Credit Opportunity Act (ECOA) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

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

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

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

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

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

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

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

Federal Home Loan Bank System. The Bank is a member of the FHLB. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. At December 31, 2016, the Bank was in compliance with the stock requirements.

Federal Reserve System. The FRB requires all depository institutions to maintain noninterest bearing reserves at specified levels against their transaction accounts (primarily checking) and non-personal time deposits. At December 31, 2016, the Bank was in compliance with these requirements.

#### Item 1A. Risk Factors

Not required as the Corporation is a smaller reporting company.

#### Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

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

The Bank owns and leases numerous other premises for use in conducting business activities. The Bank considers these facilities owned or occupied under lease to be adequate. For additional information regarding the Bank's properties, see "Note 7 - Premises and Equipment" to the consolidated financial statements on page F-24.

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## Item 3. Legal Proceedings

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

## Item 4. Mine Safety Disclosures

Not applicable.

## PART II

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

## Market, Holder and Dividend Information

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

Boenning and Scattergood, Inc.	Janney Montgomery Scott LLC	Raymond James & Associates, Inc.
4 Tower Bridge	1717 Arch Street	222 South Riverside Plaza
200 Barr Harbor Drive, Suite 300	Philadelphia, PA 19103	Suite 2680
West Conshohocken, PA 19428-2979	Telephone: (215) 665-6000	Chicago, IL 60606
Telephone: (800) 883-1212		Telephone: (312) 471-5100

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

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

	Market Price		Close	Cash Dividend
	High	Low		
2016:				
Fourth quarter	\$30.00	\$24.02	\$29.25	\$ 0.26
Third quarter	24.95	23.29	24.62	0.26
Second quarter	25.00	23.61	23.94	0.26
First quarter	25.00	22.73	25.00	0.26
2015:				
Fourth quarter	\$25.00	\$22.90	\$24.00	\$ 0.24
Third quarter	24.96	22.85	22.90	0.24
Second quarter	25.96	22.52	23.94	0.24
First quarter	27.15	23.50	25.10	0.24

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As of March 1, 2017, there were approximately 622 stockholders of record and 2,152,358 shares of common stock entitled to vote, receive dividends and considered outstanding for financial reporting purposes. The number of stockholders of record does not include the number of persons or entities who hold their stock in nominee or “street” name.

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

#### Purchases of Equity Securities

The Corporation did not repurchase any of its equity securities in the year ended December 31, 2016.

#### Item 6. Selected Financial Data

Not required as the Corporation is a smaller reporting company.

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

The following discussion and analysis represents a review of the Corporation's consolidated financial condition and results of operations for the years ended December 31, 2016 and 2015. This review should be read in conjunction with the consolidated financial statements beginning on page F-3.

##### Overview

The Corporation reported consolidated net income available to common stockholders of \$4.0 million, or \$1.85 per diluted common share, for 2016, compared to \$4.1 million, or \$2.05 per diluted common share, for 2015. Net income available to common stockholders was impacted by the following:

Net interest income increased \$1.7 million, or 9.8%, in 2016. This increase primarily related to an increase in interest income of \$2.8 million, or 13.8%, partially offset by an increase in interest expense of \$1.1 million, or 39.2%. Driving the increase in interest income was an \$84.4 million increase in the average balance of loans. The increase in interest expense was driven by increases in the Corporation's average balances of interest-bearing deposits and borrowed funds of \$52.5 million and \$16.0 million, respectively. The increases in the Corporation's interest-earning assets and interest-bearing liabilities includes the impact of the UASB acquisition, which added \$66.1 million in loans and \$72.7 million in deposits at the time of the acquisition.

Noninterest income decreased \$439,000, or 10.7%, in 2016. Net gains realized on the sale of securities decreased \$772,000, or 90.4%, to \$82,000 in 2016 from \$854,000 in 2015, while fees and service charges and gains on loans sold to the FHLB increased \$139,000 and \$119,000, respectively.

Noninterest expense increased \$1.3 million, or 7.9%, to \$17.4 million for the year ended December 31, 2016 from \$16.2 million for 2015. The increase primarily related to increases in compensation and benefits, other noninterest expense, acquisition costs and premises and equipment of \$407,000, \$269,000, \$267,000 and \$198,000, respectively. Acquisition costs related to the UASB acquisition totaled \$401,000 in 2016 and \$134,000 in 2015. Contributing to the increase in noninterest expense was the addition of the UASB branch in April 2016 and the opening of a new branch banking office in Aspinwall, Pennsylvania in August 2016.

##### Changes in Financial Condition

Total assets increased \$91.5 million, or 15.2%, to \$692.1 million at December 31, 2016 from \$600.6 million at December 31, 2015. This increase primarily related to increases in net loans receivable and cash and equivalents of \$85.5 million and \$6.0 million, respectively, partially offset by a decrease in securities available for sale of \$11.4 million. Liabilities increased \$90.3 million, or 16.5%, to \$638.1 million at December 31, 2016 from \$547.8 million at December 31, 2015 due to an increase in customer deposits of \$95.1 million, partially offset by a \$5.3 million

decrease in borrowed funds. Loans and deposits acquired from UASB totaled \$66.1 million and \$72.7 million, respectively, at the time of the acquisition in April 2016.

Cash and cash equivalents. Cash and cash equivalents increased \$6.0 million, or 52.2%, to \$17.6 million at December 31, 2016 from \$11.5 million at December 31, 2015. This increase primarily resulted from an increase in customer deposits, partially offset by the funding of loans and the repayment of borrowed funds.

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Securities. Securities decreased \$11.4 million, or 10.1%, to \$101.6 million at December 31, 2016 from \$113.0 million at December 31, 2015. This decrease primarily resulted from investment security sales, maturities, calls and repayments totaling \$29.4 million, partially offset by purchases totaling \$18.5 million during the year.

Loans receivable. Net loans receivable increased \$85.5 million, or 19.9%, to \$515.4 million at December 31, 2016 from \$429.9 million at December 31, 2015. The increase was driven by growth in the Corporation's residential mortgage, commercial mortgage and home equity portfolios of \$58.9 million, \$37.3 million and \$3.9 million, respectively, partially offset by decreases in the home equity and consumer portfolios of \$14.2 million and \$70,000, respectively. Loans acquired from UASB totaled \$66.1 million at the time of the acquisition in April 2016 and \$58.9 million at December 31, 2016. The growth of the Corporation's residential mortgage portfolio also included a loan pool purchase totaling \$6.9 million.

Nonperforming assets. Nonperforming assets include nonaccrual loans, loans 90 days past due and still accruing, repossessions and real estate owned. Nonperforming assets were \$3.6 million, or 0.52% of total assets, at December 31, 2016 compared to \$3.2 million, or 0.54% of total assets, at December 31, 2015. Nonperforming assets consisted of nonperforming loans and real estate owned of \$3.3 million and \$291,000, respectively, at December 31, 2016 and \$3.1 million and \$160,000, respectively, at December 31, 2015. At December 31, 2016, nonperforming loans consisted primarily of residential mortgage, commercial mortgage and commercial business loans.

Federal bank stocks. Federal bank stocks were comprised of FHLB stock and FRB stock of \$3.6 million and \$1.3 million, respectively, at December 31, 2016. These stocks are purchased and redeemed at par as directed by the federal banks and levels maintained are based primarily on borrowing and other correspondent relationships between the Corporation and the Federal Banks.

Bank-owned life insurance (BOLI). The Corporation maintains single premium life insurance policies on certain current and former officers and employees of the Bank. In addition to providing life insurance coverage, whereby the Bank as well as the officers and employees receive life insurance benefits, the appreciation of the cash surrender value of the BOLI will serve to offset and finance existing and future employee benefit costs. Increases in this account are typically associated with an increase in the cash surrender value of the policies, partially offset by certain administrative expenses. BOLI increased \$334,000, or 3.0%, to \$11.4 million at December 31, 2016 from \$11.1 million at December 31, 2015.

Premises and equipment. Premises and equipment increased \$2.2 million, or 13.5%, to \$18.3 million at December 31, 2016 from \$16.1 million at December 31, 2015. The overall increase in premises and equipment during the year was due to capital expenditures of \$3.3 million, partially offset by depreciation and amortization of \$1.1 million. Additions for 2016 included \$1.2 million of fixed assets acquired from UASB and the purchase of facilities and equipment related to the new branch banking office in Aspinwall, Pennsylvania, which opened in August 2016.

Goodwill. Goodwill increased \$6.6 million to \$10.3 million at December 31, 2016 from \$3.7 million at December 31, 2015. During 2016, the Corporation recorded \$6.6 million of goodwill related to the acquisition of UASB. Goodwill represents the excess of the total purchase price paid for the acquisition over the fair value of the identifiable assets acquired, net of the fair value of the liabilities assumed. Goodwill is evaluated for impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. Management evaluated goodwill and concluded that no impairment existed at December 31, 2016.

Core deposit intangible. The core deposit intangible was \$560,000 at December 31, 2016, compared to \$554,000 at December 31, 2015. During 2016, the Corporation recorded a core deposit intangible of \$232,000 related to the UASB acquisition. The core deposit intangible also includes amounts associated with the assumption of deposits in the 2009

Titusville branch acquisition. This asset represents the long-term value of the core deposits acquired. In each instance, the fair value was determined using a third-party valuation expert specializing in estimating fair values of core deposit intangibles. The fair value was derived using an industry standard financial instrument present value methodology. All-in costs and runoff balances by year were discounted by comparable term FHLB advance rates, used as an alternative cost of funds measure. This intangible asset amortizes utilizing the double declining balance method of amortization over a weighted average estimated life of the related deposits. The core deposit intangible asset is not estimated to have a significant residual value. The Corporation recorded \$226,000 and \$195,000 of intangible amortization in 2016 and 2015, respectively.

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Deposits. Total deposits increased \$95.1 million, or 19.4%, to \$584.9 million at December 31, 2016 from \$489.9 million at December 31, 2015. Noninterest bearing deposits increased \$3.9 million, or 3.3%, during the year while interest bearing deposits increased \$91.1 million, or 24.6%. Deposits assumed from UASB totaled \$72.7 million at the time of the acquisition in April 2016 and \$57.7 million at December 31, 2016. Also contributing to the increase in deposits were municipal customers depositing funds in early 2016 after not receiving timely payments of anticipated government funding at the end of 2015 due to the Pennsylvania state budget impasse.

Borrowed funds. Borrowed funds decreased \$5.3 million, or 10.7%, to \$44.0 million at December 31, 2016 from \$49.3 million at December 31, 2015. Borrowed funds at December 31, 2016 consisted of short-term borrowings of \$9.5 million and long-term borrowings of \$30.0 million. Long-term advances are utilized primarily to fund loan growth and short-term advances are utilized primarily to compensate for the normal deposit fluctuations.

Stockholders' equity. Stockholders' equity increased \$1.2 million, or 2.3%, to \$54.1 million at December 31, 2016 from \$52.8 million at December 31, 2015. The increase primarily related to a \$1.8 million increase in retained earnings as a result of net income totaling \$4.0 million, less dividends paid of \$2.2 million. This increase was partially offset by a \$729,000 decrease in accumulated other comprehensive income resulting from changes in the net unrealized losses on securities available for sale and the funded status of the Corporation's defined benefit plan.

#### Changes in Results of Operations

The Corporation reported net income before preferred stock dividends of \$4.0 million and \$4.2 million in 2016 and 2015, respectively. The following "Average Balance Sheet and Yield/Rate Analysis" and "Analysis of Changes in Net Interest Income" tables should be utilized in conjunction with the discussion of the interest income and interest expense components of net interest income.

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

(Dollar amounts in thousands)	For the year ended December 31,					
	2016			2015		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$459,253	\$19,966	4.35%	\$375,164	\$16,706	4.45%
Loans, tax-exempt	25,893	1,206	4.66%	25,535	1,244	4.87%
Total loans receivable	485,146	21,172	4.36%	400,699	17,950	4.48%
Securities, taxable	78,767	1,662	2.11%	107,009	1,965	1.84%
Securities, tax-exempt	28,453	865	3.04%	31,879	1,126	3.53%
Total securities	107,220	2,527	2.36%	138,888	3,091	2.23%
Federal bank stocks	3,758	186	4.95%	2,419	164	6.78%
Interest-earning deposits with banks	25,563	135	0.53%	12,328	68	0.55%
Total interest-earning cash equivalents	29,321	321	1.09%	14,747	232	1.57%
Total interest-earning assets	621,687	24,020	3.86%	554,334	21,273	3.84%
Cash and due from banks	2,577			2,440		
Other noninterest-earning assets	42,490			34,347		
Total Assets	\$666,754			\$591,121		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$290,559	607	0.21%	\$272,582	412	0.15%
Time deposits	153,268	2,184	1.42%	118,701	1,732	1.46%
Total interest-bearing deposits	443,827	2,791	0.63%	391,283	2,144	0.55%
Borrowed funds, short-term	2,341	78	3.34%	6,284	87	1.38%
Borrowed funds, long-term	35,141	1,076	3.06%	15,205	604	3.97%
Total borrowed funds	37,482	1,154	3.08%	21,489	691	3.21%
Total interest-bearing liabilities	481,309	3,945	0.82%	412,772	2,835	0.69%
Noninterest-bearing demand deposits	122,181	—	—	117,455	—	—
Funding and cost of funds	603,490	3,945	0.65%	530,227	2,835	0.53%
Other noninterest-bearing liabilities	8,832			8,254		
Total Liabilities	612,322			538,481		
Stockholders' Equity	54,432			52,640		
Total Liabilities and Stockholders' Equity	\$666,754			\$591,121		
Net interest income		\$20,075			\$18,438	
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			3.04%			3.15%
Net interest margin (net interest income as a percentage of average interest-earning assets)			3.23%			3.33%



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

(Dollar amounts in thousands)	2016 versus 2015		
	Increase (decrease) due		
	to		
	Volume	Rate	Total
Interest income:			
Loans	\$3,696	\$(474)	\$3,222
Securities	(738)	) 174	(564)
Interest-earning deposits with banks	70	(3)	) 67
Federal bank stocks	74	(52)	) 22
Total interest-earning assets	3,102	(355)	) 2,747
Interest expense:			
Deposits	308	339	647
Borrowed funds, short term	(79)	) 70	(9)
Borrowed funds, long term	638	(166)	) 472
Total interest-bearing liabilities	867	243	1,110
Net interest income	\$2,235	\$(598)	\$1,637

#### 2016 Results Compared to 2015 Results

The Corporation reported net income before preferred stock dividends of \$4.0 million and \$4.2 million for 2016 and 2015, respectively. The \$168,000, or 4.0%, decrease in net income was attributed to increases in noninterest expense, the provision for income taxes and the provision for loan losses of \$1.3 million, \$107,000 and \$83,000, respectively, and a decrease in noninterest income of \$439,000, partially offset by an increase in net interest income of \$1.7 million. Returns on average equity and assets were 7.32% and 0.60%, respectively, for 2016.

Net interest income. The primary source of the Corporation's revenue is net interest income. Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowed funds, used to fund the earning assets. Net interest income is impacted by the volume and composition of interest-earning assets and interest-bearing liabilities, and changes in the level of interest rates. Tax equivalent net interest income increased \$1.6 million to \$20.1 million for 2016, compared to \$18.4 million for 2015. This increase in net interest income can be attributed to an increase in tax equivalent interest income of \$2.7 million, partially offset by an increase in interest expense of \$1.1 million.

Interest income. Tax equivalent interest income increased \$2.7 million, or 12.9%, to \$24.0 million for 2016, compared to \$21.3 million for 2015. This increase can be attributed to increases in interest earned on loans and deposits with

banks and dividends received on federal bank stocks of \$530,000 and \$19,000, respectively, partially offset by decreases in securities and interest earning cash equivalents of \$3.2 million, \$67,000 and \$22,000, respectively.

Tax equivalent interest earned on loans receivable increased \$3.2 million, or 17.9%, to \$21.2 million for 2016, compared to \$18.0 million for 2015. The average balance of loans increased \$84.4 million, or 21.1%, generating \$3.7 million of additional interest income on loans. Offsetting this favorable variance, the average yield on loans decreased 12 basis points to 4.36% for 2016, versus 4.48% for 2015 causing a \$474,000 decrease in interest income.

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Tax equivalent interest earned on securities decreased \$564,000, or 18.2%, to \$2.5 million for 2016, compared to \$3.1 million for 2015. The average balance of securities decreased \$31.7 million, or 22.8%, causing a \$738,000 decrease in interest income. Partially offsetting the unfavorable volume variance, the average yield on securities increased 13 basis points to 2.36% for 2016 versus 2.23% for 2015 causing a \$174,000 increase in interest income.

Interest earned on interest-earning deposit accounts increased \$67,000, or 98.5%, to \$135,000 for 2016, compared to \$68,000 for 2015. The average balance of interest-earning deposits increased \$13.2 million causing a \$70,000 increase in interest income. Partially offsetting this unfavorable variance, the average yield on these accounts decreased 2 basis points to 0.53% for 2016 versus 0.55% for 2015 causing a \$3,000 decrease in interest income.

Interest earned on federal bank stocks increased \$22,000, or 13.4%, to \$186,000 for 2016, compared to \$164,000 for 2015. The average balance of federal bank stocks increased \$1.3 million, or 55.4%, generating a \$74,000 increase in interest income. Partially offsetting this favorable variance, the average yield on these accounts decreased 183 basis points to 4.95% for 2016 versus 6.78% for 2015 causing a \$52,000 decrease in interest income.

Interest expense. Interest expense increased \$1.1 million, or 39.2%, to \$3.9 million for 2016, compared to \$2.8 million for 2015. This increase can be attributed to increases in interest expense on interest-bearing deposits and borrowing funds of \$647,000 and \$463,000, respectively.

Interest expense on deposits increased \$647,000, or 30.2%, to \$2.8 million for 2016, compared to \$2.1 million for 2015. The average rate on interest-bearing deposits increased by 8 basis points to 0.63% for 2016 versus 0.55% for 2015 causing a \$339,000 increase in interest expense. The average balance of interest-bearing deposits increased \$52.5 million, or 13.4%, causing a \$308,000 increase in interest expense.

Interest expense on borrowed funds increased \$463,000, or 67.0%, to \$1.2 million for 2016, compared to \$691,000 for 2015. The average balance of borrowed funds increased \$16.0 million, or 74.4%, to \$37.5 million for 2016, compared to \$21.5 million for 2015 causing a \$559,000 increase in interest expense. This increase resulted primarily from the addition of four \$5.0 million long-term advances late in the fourth quarter of 2015, one of which was repaid during the second quarter of 2016. Partially offsetting this unfavorable variance, the average cost of borrowed funds decreased 13 basis points to 3.08% for 2016 versus 3.21% for 2015 causing a \$96,000 decrease in interest expense. This was primarily the result of the relatively lower cost of the borrowings added late in 2015.

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

Nonperforming loans increased \$254,000, or 8.3%, to \$3.3 million at December 31, 2016 from \$3.1 million at December 31, 2015. The increase in nonperforming loans was primarily related to a \$557,000 loan being placed on nonaccrual status during the year, partially offset by the payoff of a \$161,000 nonperforming loan.

The provision for loan losses increased \$83,000, or 21.8%, to \$464,000 for 2016 from \$381,000 for 2015. The Corporation's allowance for loan losses amounted to \$5.5 million, or 1.06% of the Corporation's total loan portfolio at December 31, 2016 compared to \$5.2 million or 1.20% of total loans at December 31, 2015. The allowance for loan losses, as a percentage of nonperforming loans at December 31, 2016 and 2015, was 166.9% and 169.6%, respectively. The allocation of the allowance for loan losses related to residential mortgage loans and commercial

mortgage loans increased during the year as a result of growth in the loan portfolios, while the allocation related to commercial business loans decreased as the portfolio decreased. At December 31, 2016, there was no provision for loan losses allocated to loans acquired in the acquisition of UASB in April 2016. If the loans acquired from UASB with balances of \$58.9 million were excluded, the ratio of allowance to total loans at the December 31, 2016 would have been 1.20%.

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Noninterest income. Noninterest income includes revenue that is related to services rendered and activities conducted in the financial services industry, including fees on depository accounts, general transaction and service fees, commissions on financial services, title premiums, security and loan sale gains and losses, and earnings on bank-owned life insurance (BOLI). Noninterest income decreased \$439,000, or 10.7%, to \$3.7 million in 2016 from \$4.1 million in 2015. This decrease was primarily due to a \$772,000 decrease in gains on the sale of securities. In 2016, the Corporation realized securities gains of \$82,000 compared to \$854,000 realized in 2015, of which \$298,000 related to the sale of community bank stock and \$556,000 related to the sale of securities to accommodate loan growth. Partially offsetting this decrease in noninterest income, fees and service charges and other noninterest income increased by \$139,000 and \$11,000, respectively. Additionally, the Corporation recognized \$119,000 in gains on loans sold to the FHLB during 2016.

Noninterest expense. Noninterest expense increased \$1.3 million, or 7.9%, to \$17.4 million for 2016, compared to \$16.2 million for 2015. This increase was primarily related to increases in compensation and employee benefits, other noninterest expense, acquisition costs, premises and equipment expense, professional fees, federal deposit insurance and intangible asset amortization.

The largest component of noninterest expense, compensation and employee benefits, increased \$407,000, or 5.0%, to \$8.6 million for 2016, compared to \$8.2 million for 2015. This increase primarily related to normal wage and salary increases and an increase in retirement benefits expense as well as the addition of two branch offices acquired or opened during the year.

Other noninterest expense increased \$269,000, or 7.1%, to \$4.0 million for 2016, compared to \$3.8 million for 2015. Included in other noninterest expense for 2016 was \$71,000 in prepayment penalties incurred in the second quarter of 2016 associated with the early retirement of a \$5.0 million FHLB long-term advance. Additionally, printing and office supplies, telephone and communications expense, marketing expense, postage, and correspondent and courier fees increased \$63,000, \$50,000, \$47,000, \$45,000 and \$40,000, respectively, partially due to normal operating increases and the additional two branch offices during the year.

Acquisition costs increased \$267,000 to \$401,000 for 2016, compared to \$134,000 for 2015. Acquisition costs for both years were related to the acquisition of UASB which was completed on April 30, 2016. Acquisition costs for 2016 included legal fees, system conversion costs and other costs of \$194,000, \$132,000 and \$75,000, respectively.

Premises and equipment expense increased \$198,000, or 7.5%, to \$2.8 million for 2016, compared to \$2.7 million for 2015. This increase primarily related to expenses associated with the Bank's new branch offices and an increase in depreciation expense due to an upgrade to the Bank's mainframe and disaster recovery equipment in late 2015.

The Corporation recognized \$226,000 of intangible amortization in 2016, compared to \$195,000 in 2015 associated with core deposit intangible assets that were recorded in connection with the 2009 Titusville branch acquisition and the 2016 UASB acquisition.

The provision for income taxes increased \$107,000, or 9.4%, to \$1.2 million for 2016, compared to \$1.1 million for 2015 primarily due to an increase in taxable income. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 23.8% for 2016 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## Market Risk Management



Market risk for the Corporation consists primarily of interest rate risk exposure and liquidity risk. The Corporation is not subject to currency exchange risk or commodity price risk, and has no trading portfolio, and therefore, is not subject to any trading risk. In addition, the Corporation does not participate in hedging transactions such as interest rate swaps and caps. Changes in interest rates will impact both income and expense recorded and also the market value of long-term interest-earning assets.

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

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

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

#### Interest Rate Sensitivity Gap Analysis

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

The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within that time period. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities, and is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero, or more neutral, that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

Based on certain assumptions derived from the Corporation's historical experience, at December 31, 2016, the Corporation's interest-earning assets maturing or repricing within one year totaled \$188.9 million while the Corporation's interest-bearing liabilities maturing or repricing within one year totaled \$192.2 million, providing an excess of interest-bearing liabilities over interest-earning assets of \$3.3 million or 0.5% of total assets. At December 31, 2016, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 98.3%.

The following table presents the amounts of interest-earning assets and interest-bearing liabilities outstanding as of December 31, 2016 which are expected to mature, prepay or reprice in each of the future time periods presented:

(Dollar amounts in thousands)	Six months or less	Six months to one year	One to three years	Three to four years	Over four years	Total
Total interest-earning assets	\$135,637	\$53,291	\$166,258	\$59,447	\$222,289	\$636,922
Total interest-bearing liabilities	94,503	97,708	204,217	26,312	77,979	500,719
Interest rate sensitivity gap	\$41,134	\$(44,417)	\$(37,959)	\$33,135	\$144,310	\$136,203
Cumulative rate sensitivity gap	\$41,134	\$(3,283)	\$(41,242)	\$(8,107)	\$136,203	
Ratio of gap during the period to total interest earning assets	6.46	% (6.97)	% (5.96)	% 5.20	% 22.66	%
Ratio of cumulative gap to total interest earning assets	6.46	% (0.52)	% (6.48)	% (1.27)	% 21.38	%

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

#### Interest Rate Sensitivity Simulation Analysis

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

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

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

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

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

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

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The following table presents the simulated impact of a 100 basis point or 200 basis point upward or downward shift of market interest rates on net interest income for the years ended December 31, 2016 and 2015, respectively. This analysis was done assuming that the interest-earning asset and interest-bearing liability levels at December 31, 2016 remained constant. The impact of the market rate movements on net interest income was developed by simulating the effects of rates changing immediately for a one-year period from the December 31, 2016 levels for net interest income.

	Increase		Decrease	
	+100 BP	+200 BP	-100 BP	-200 BP
2016 Net interest income - increase (decrease)	(0.77)%	(1.90)%	(2.56)%	(6.48)%
2015 Net interest income - increase (decrease)	(0.36)%	(1.14)%	(2.80)%	(6.67)%

The expected decrease in net interest income in the rising rate scenarios shown in the table above resulted from the Corporation having overnight borrowings of \$7.0 million and \$14.5 million at December 31, 2016 and 2015, respectively. In a rising rate environment, these borrowings would be immediately repricing, therefore causing increased interest expense.

#### Impact of Inflation and Changing Prices

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

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

#### Capital Resources

Total stockholders' equity increased \$1.2 million, or 2.3%, to \$54.1 million at December 31, 2016 from \$52.8 million at December 31, 2015. Net income before preferred stock dividends of \$4.0 million in 2016 represented a decrease in earnings of \$168,000, or 4.0%, compared to 2015.

The Corporation's capital to assets ratio decreased to 7.8% at December 31, 2016 from 8.8% at December 31, 2015. This was due to a \$91.5 million increase in the Corporation's assets primarily related to the acquisition of UASB during 2016. To prepare for this asset growth, during the second quarter of 2015, the Corporation raised \$8.2 million in capital, net of expenses, through the issuance of 350,000 shares of common stock in a private placement offering to accredited investors. Also, during the third quarter of 2015, the Corporation utilized a portion of the proceeds of the stock offering to redeem the remaining \$5.0 million of preferred stock issued to the U.S. Treasury under the SBLF program.

While continuing to sustain a strong capital position, dividends on common stock increased to \$2.2 million in 2016 from \$1.9 million in 2015. In addition, stockholders have taken part in the Corporation's dividend reinvestment plan

introduced during 2003 with 44% of registered shareholder accounts active in the plan at December 31, 2016. Dividend reinvestment is achieved through the purchase of common shares on the secondary market.

Capital adequacy is intended to enhance the Corporation's ability to support growth while protecting the interest of stockholders and depositors and to ensure that capital ratios are in compliance with regulatory minimum requirements. Regulatory agencies have developed certain capital ratio requirements that are used to assist them in monitoring the safety and soundness of financial institutions. At December 31, 2016, the Bank was in excess of all regulatory capital requirements. See Note 12 to the Corporation's consolidated financial statements attached hereto.

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## Liquidity

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB, and amortization and prepayments of outstanding loans and maturing securities. During 2016, the Corporation used its sources of funds primarily to fund loan commitments and repay borrowed funds. As of December 31, 2016, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$92.5 million, and standby letters of credit totaling \$76,000, net of collateral maintained by the Bank. The Bank is required by the OCC to establish policies to monitor and manage liquidity levels to ensure the Bank's ability to meet demands for customer withdrawals and the repayment of short-term borrowings, and at December 31, 2016, the Bank was in compliance with all liquidity policy limits.

At December 31, 2016, time deposits amounted to \$157.0 million, or 26.8%, of the Corporation's total consolidated deposits, including approximately \$47.1 million scheduled to mature within the next year. Management believes that the Corporation has adequate resources to fund all of its commitments, that all of its commitments will be funded as required by related maturity dates and that, based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation and the Bank have alternative sources of funds. These sources include a line of credit for the Corporation with a correspondent bank, the Bank's line of credit and term borrowing capacity from the FHLB and, to a more limited extent, through the sale of loans. At December 31, 2016, the Bank's borrowing capacity with the FHLB, net of funds borrowed and irrevocable standby letters of credit issued to secure certain deposit accounts, was \$122.5 million.

The Corporation pays a regular quarterly cash dividend. The Corporation paid dividends of \$0.26 and \$0.24 per common share for each of the four quarters of 2016 and 2015, respectively. On February 15, 2017, the Corporation declared a quarterly dividend of \$0.27 per common share payable on March 17, 2017 to shareholders of record on March 1, 2017. The determination of future dividends on the Corporation's common stock will depend on conditions existing at that time with consideration given to the Corporation's earnings, capital and liquidity needs, among other factors.

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

## Critical Accounting Policies

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

management primarily through the use of internal cash flow modeling techniques.

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions, and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies:

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

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

Goodwill and intangible assets. Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. Goodwill is subject to ongoing periodic impairment tests based on the fair value of the reporting unit compared to its carrying amount, including goodwill. Impairment exists when a reporting unit's carrying amount exceeds its fair value. At November 30, 2016, the required annual impairment test of goodwill was performed and no impairment existed as of the valuation date. If for any future period it is determined that there has been impairment in the carrying value of our goodwill balances, the Corporation will record a charge to earnings, which could have a material adverse effect on net income, but not risk based capital ratios.

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

Information required by this item is included in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7.

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

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

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

Not applicable.

#### Item 9A. Controls and Procedures

The Corporation maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to

the Corporation's management, including its CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e).

As of December 31, 2016, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective.

During the fourth quarter of fiscal year 2016, there has been no change made in the Corporation's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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There have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its valuation.

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

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

Management completed an assessment of the Corporation's internal control over financial reporting as of December 31, 2016. This assessment was based on criteria for evaluating internal control over financial reporting established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concluded that the Corporation's internal control over financial reporting was effective as of December 31, 2016.

#### Item 9B. Other Information

None.

### PART III

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

The information required by this item is incorporated herein by reference to the sections captioned "Principal Beneficial Owners of the Corporation's Common Stock", "Section 16(a) Beneficial Ownership Reporting Compliance" and "Information With Respect to Nominees For Director, Continuing Director and Executive Officers" in the Corporation's definitive proxy statement for the Corporation's Annual Meeting of Stockholders to be held on April 26, 2017 (the Proxy Statement).

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

#### Item 11. Executive Compensation

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

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

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

Equity Compensation Plan Information. The following table provides certain information as of December 31, 2016 with respect to shares of common stock that may be issued under our equity compensation plans, which consists of the 2007 Stock Incentive Plan and Trust, which was approved by shareholders in April 2007 and the 2014 Stock Incentive

Plan, which was approved by shareholders in April 2014.

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Plan Category	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options (1)	Number of securities remaining available for issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	62,000	\$ 25.71	210,512
Equity compensation plans not approved by security holders	0	—	0
Total	62,000	\$ 25.71	210,512

(1) Options outstanding have been granted pursuant to the 2007 Stock Incentive Plan and Trust (Plan). The Plan provides for the grant of options to purchase up to 126,783 shares of common stock of which options to purchase 62,000 shares were outstanding at December 31, 2016. In addition, 8,500 shares of common stock have been issued upon exercise of options. The Plan also provides for grants of up to 50,713 shares of restricted common stock of which 50,700 shares have been granted. In addition, the 2014 Stock Incentive Plan provides for the grant of options to purchase up to 88,433 shares of common stock and for grants of up to 88,433 shares of restricted common stock of which no options and 22,650 shares of restricted stock have been granted.

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

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

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

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

### PART IV

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

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

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

##### (3) Management Contracts or Compensatory Plans:

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

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

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- 3.1 Articles of Incorporation of Emclaire Financial Corp (1)
- 3.2 Bylaws of Emclaire Financial Corp (1)
- 4.0 Specimen Common Stock Certificate of Emclaire Financial Corp (2)
- 10.1 Amended and Restated Employment Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and William C. Marsh, dated as of November 18, 2015. (3)\*
- 10.2 Amended and Restated Change in Control Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and Matthew J. Lucco, dated as of November 18, 2015. (3)\*
- 10.3 Amended and Restated Change in Control Agreement between Emclaire Financial Corp, The Farmers National Bank of Emlenton and Amanda L. Engles, dated as of November 18, 2015. (3)\*
- 10.4 Amended and Restated Supplemental Executive Retirement Plan Agreement between The Farmers National Bank of Emlenton and William C. Marsh, dated as of November 18, 2015. (3)\*
- 10.5 Amended and Restated Supplemental Executive Retirement Plan Agreement between The Farmers National Bank of Emlenton and Matthew J. Lucco, dated as of November 18, 2015. (3)\*
- 10.6 Group Term Carve-Out Plan between the Farmers National Bank of Emlenton and Officers and Employees. (4)\*
- 10.7 Farmers National Bank of Emlenton Deferred Compensation Plan. (5)\*
- 10.8 Emclaire Financial Corp 2007 Stock Incentive Plan and Trust. (6)\*
- 10.9 Emclaire Financial Corp 2014 Stock Incentive Plan. (7)\*
- 11.0 Statement regarding computation of earnings per share (see Note 1 of the Notes to Consolidated Financial Statements in the Annual Report).
- 14.0 Code of Personal and Business Conduct and Ethics. (8)
- 20.0 Emclaire Financial Corp Dividend Reinvestment and Stock Purchase Plan. (9)
- 21.0 Subsidiaries of the Registrant (see information contained herein under “Item 1. Description of Business - Subsidiary Activity”).
- 31.1 Principal Executive Officer Section 302 Certification.
- 31.2 Principal Financial Officer Section 302 Certification.
- 32.1 Principal Executive Officer Section 906 Certification.
- 32.2 Principal Financial Officer Section 906 Certification.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definitions Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

\*Compensatory plan or arrangement.

- (1) Incorporated by reference to the Registrant’s Registration Statement on Form SB-2, as amended, (File No. 333-11773) declared effective by the SEC on October 25, 1996.
- (2) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 1997.
- (3) Incorporated by reference to the Registrant’s Current Report on Form 8-K dated November 18, 2015.
- (4) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2002.
- (5) Incorporated by reference to the Registrant’s Current Report on Form 8-K dated December 15, 2008.
- (6) Incorporated by reference to the Registrant’s Definitive Proxy Statement dated March 23, 2007.
- (7) Incorporated by reference to the Registrant’s Definitive Proxy Statement dated March 24, 2016.
- (8) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2004.
- (9) Incorporated by reference to the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2001.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EMCLAIRE FINANCIAL CORP

Dated: March 24, 2017 By: /s/ William C. Marsh

William C. Marsh

Chairman, Chief Executive Officer, President and Director

(Duly Authorized Representative)

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

By: /s/ William C. Marsh

William C. Marsh

Chairman of the Board

Chief Executive Officer

President

Director

(Principal Executive Officer)

By: /s/ Matthew J. Lucco

Matthew J. Lucco

Treasurer and Chief Financial Officer

(Principal Financial Officer)

Date: March 24, 2017

Date: March 24, 2017 By: /s/ Amanda L. Engles

Amanda L. Engles

Secretary

(Principal Accounting Officer)

Date: March 24, 2017

By: /s/ Milissa S. Bauer By: /s/ David L. Cox

Milissa S. Bauer

Director

David L. Cox

Director

Date: March 24, 2017 Date: March 24, 2017

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

James M. Crooks

Director

Robert W. Freeman

Director

Date: March 24, 2017 Date: March 24, 2017

By: /s/ Mark A. Freemer By: /s/ Robert L. Hunter

Mark A. Freemer

Director

Robert L. Hunter

Director

Date: March 24, 2017 Date: March 24, 2017

/s/ John B. Mason By: /s/ Deanna K. McCarrier

John B. Mason

Director

Deanna K. McCarrier

Director

Date: March 24, 2017 Date: March 24, 2017

By: /s/ Nicholas D. Varischetti

Nicholas D. Varischetti

Director

Date: March 24, 2017



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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders  
Emclaire Financial Corp  
Emlenton, Pennsylvania

We have audited the accompanying consolidated balance sheets of Emclaire Financial Corp as of December 31, 2016 and 2015, and the related consolidated statements of net income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Emclaire Financial Corp as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ Crowe Horwath LLP

Cleveland, Ohio  
March 24, 2017

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## Consolidated Balance Sheets

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

	December 31,	
	2016	2015
Assets		
Cash and due from banks	\$2,758	\$2,359
Interest earning deposits with banks	14,810	9,187
Total cash and cash equivalents	17,568	11,546
Securities available for sale	101,560	112,981
Loans receivable, net of allowance for loan losses of \$5,545 and \$5,205	515,435	429,891
Loans held for sale	68	—
Federal bank stocks, at cost	4,861	4,240
Bank-owned life insurance	11,390	11,056
Accrued interest receivable	1,815	1,501
Premises and equipment, net	18,282	16,114
Goodwill	10,288	3,664
Core deposit intangible, net	560	554
Prepaid expenses and other assets	10,308	9,048
Total Assets	\$692,135	\$600,595
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Non-interest bearing	\$123,717	\$119,790
Interest bearing	461,223	370,097
Total deposits	584,940	489,887
Borrowed funds	44,000	49,250
Accrued interest payable	239	179
Accrued expenses and other liabilities	8,883	8,440
Total Liabilities	638,062	547,756
Commitments and Contingent Liabilities (Note 13)		
Stockholders' Equity		
Common stock, \$1.25 par value, 12,000,000 shares authorized; 2,254,375 and 2,246,825 shares issued; 2,152,358 and 2,144,808 shares outstanding	2,818	2,808
Additional paid-in capital	27,900	27,701
Treasury stock, at cost; 102,017 shares	(2,114 )	(2,114 )
Retained earnings	29,960	28,206
Accumulated other comprehensive loss	(4,491 )	(3,762 )
Total Stockholders' Equity	54,073	52,839
Total Liabilities and Stockholders' Equity	\$692,135	\$600,595

See accompanying notes to consolidated financial statements.

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## Consolidated Statements of Net Income

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

	Year ended	
	December 31,	
	2016	2015
Interest and dividend income		
Loans receivable, including fees	\$20,814	\$17,578
Securities:		
Taxable	1,662	1,965
Exempt from federal income tax	628	807
Federal bank stocks	186	164
Deposits with banks	135	68
Total interest and dividend income	23,425	20,582
Interest expense		
Deposits	2,791	2,144
Short-term borrowed funds	78	87
Long-term borrowed funds	1,076	604
Total interest expense	3,945	2,835
Net interest income	19,480	17,747
Provision for loan losses	464	381
Net interest income after provision for loan losses	19,016	17,366
Noninterest income		
Fees and service charges	1,616	1,477
Net gain on sales of available for sale securities	82	854
Net gain on sales of loans	119	—
Earnings on bank-owned life insurance	406	396
Other	1,432	1,367
Total noninterest income	3,655	4,094
Noninterest expense		
Compensation and employee benefits	8,630	8,223
Premises and equipment	2,849	2,651
Intangible asset amortization	226	195
Professional fees	876	816
Federal deposit insurance	416	376
Acquisition costs	401	134
Other	4,039	3,770
Total noninterest expense	17,437	16,165
Income before provision for income taxes	5,234	5,295
Provision for income taxes	1,248	1,141
Net income	3,986	4,154
Preferred stock dividends	—	75
Net income available to common stockholders	\$3,986	\$4,079
Earnings per common share		
Basic	\$1.86	\$2.06
Diluted	\$1.85	\$2.05

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Comprehensive Income  
(Dollar amounts in thousands)

	Year ended December 31,	
	2016	2015
Net income	\$3,986	\$4,154
Other comprehensive loss		
Unrealized gains/(losses) on securities:		
Unrealized holding gain (loss) arising during the period	(571 )	179
Reclassification adjustment for gains included in net income	(82 )	(854 )
	(653 )	(675 )
Tax effect	222	229
Net of tax	(431 )	(446 )
Defined benefit pension plans:		
Net loss arising during the period	(671 )	(657 )
Reclassification adjustment for amortization of prior service benefit and net loss included in net periodic pension cost	220	